H.R. 3298, THE NATIONAL PROPERTY REINSURANCE ACT OF 1993

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MAY 19, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 103–141

U.S. GOVERNMENT PRINTING OFFICE

79–479 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046700-4

1153

H.R. 3298, THE NATIONAL PROPERTY REINSURANCE ACT OF 1993

__ARING

BEFORE THE

SUBCOMMITTEE ON
CONSUMER CREDIT AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MAY 19, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 103–141

U.S. GOVERNMENT PRINTING OFFICE

79–479 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046700-4

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HENRY B. GONZALEZ, Texas, *Chairman*

STEPHEN L. NEAL, North Carolina
JOHN J. LAFALCE, New York
BRUCE F. VENTO, Minnesota
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
JOSEPH P. KENNEDY II, Massachusetts
FLOYD H. FLAKE, New York
KWEISI MFUME, Maryland
MAXINE WATERS, California
LARRY LAROCCO, Idaho
BILL ORTON, Utah
JIM BACCHUS, Florida
HERBERT C. KLEIN, New Jersey
CAROLYN B. MALONEY, New York
PETER DEUTSCH, Florida
LUIS V. GUTIERREZ, Illinois
BOBBY L. RUSH, Illinois
LUCILLE ROYBAL-ALLARD, California
THOMAS M. BARRETT, Wisconsin
ELIZABETH FURSE, Oregon
NYDIA M. VELAZQUEZ, New York
ALBERT R. WYNN, Maryland
CLEO FIELDS, Louisiana
MELVIN WATT, North Carolina
MAURICE HINCHEY, New York
CALVIN M. DOOLEY, California
RON KLINK, Pennsylvania
ERIC FINGERHUT, Ohio

JAMES A. LEACH, Iowa
BILL McCOLLUM, Florida
MARGE ROUKEMA, New Jersey
DOUG BEREUTER, Nebraska
THOMAS J. RIDGE, Pennsylvania
TOBY ROTH, Wisconsin
ALFRED A. (AL) McCANDLESS, California
RICHARD H. BAKER, Louisiana
JIM NUSSLE, Iowa
CRAIG THOMAS, Wyoming
SAM JOHNSON, Texas
DEBORAH PRYCE, Ohio
JOHN LINDER, Georgia
JOE KNOLLENBERG, Michigan
RICK LAZIO, New York
ROD GRAMS, Minnesota
SPENCER BACHUS, Alabama
MIKE HUFFINGTON, California
MICHAEL CASTLE, Delaware
PETER KING, New York

BERNARD SANDERS, Vermont

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

JOSEPH P. KENNEDY II, Massachusetts, *Chairman*

HENRY B. GONZALEZ, Texas
LARRY LAROCCO, Idaho
LUIS V. GUTIERREZ, Illinois
BOBBY L. RUSH, Illinois
LUCILLE ROYBAL-ALLARD, California
THOMAS M. BARRETT, Wisconsin
ELIZABETH FURSE, Oregon
NYDIA M. VELAZQUEZ, New York
ALBERT R. WYNN, Maryland
CLEO FIELDS, Louisiana
MELVIN WATT, North Carolina
MAURICE HINCHEY, New York
PAUL E. KANJORSKI, Pennsylvania
FLOYD H. FLAKE, New York
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
PETER DEUTSCH, Florida

ALFRED A. (AL) McCANDLESS, California
MICHAEL CASTLE, Delaware
PETER KING, New York
DEBORAH PRYCE, Ohio
JOHN LINDER, Georgia
JOE KNOLLENBERG, Michigan
DOUG BEREUTER, Nebraska
CRAIG THOMAS, Wyoming
RICK LAZIO, New York
ROD GRAMS, Minnesota
SPENCER BACHUS, Alabama
RICHARD H. BAKER, Louisiana

BERNARD SANDERS, Vermont

CONTENTS

H.R. 3298, THE NATIONAL PROPERTY REINSURANCE ACT OF 1993

THURSDAY, MAY 19, 1994

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2220, Rayburn House Office Building, Hon. Maxine Waters [chairman pro tempore of the subcommittee] presiding.

Present: Chairman [pro tem] Waters, Representatives Gutierrez, Roybal-Allard, Barrett, Velazquez, Knollenberg, and Sanders.

Ms. WATERS. The Consumer Credit and Insurance Subcommittee will come to order.

Today, we are without the chairperson of this subcommittee. Congressman Kennedy cannot be here. There is illness in the family, and he had to be with his family today. So we are going to proceed with this hearing, and I am going to substitute for Mr. Kennedy and chair this subcommittee.

With that, I would like to ask members for opening statements.

Mr. Knollenberg, do you have an opening statement?

Mr. KNOLLENBERG. I do. Thank you. I have a brief opening statement.

I want to thank the Chair, and I want to also thank the witnesses in advance who have taken the time to come before this subcommittee. I am looking forward to your testimony.

In my view, there are several points relating to the reinsurance market that need to be addressed before we can call the hearing a success. Number one, we must determine whether we are dealing with the wholesale failure of the reinsurance market or just problems with the cost of reinsurance in a high-risk neighborhood or in high-risk neighborhoods.

Second, what do the facts surrounding this issue tell us? Have a lot of companies been denied reinsurance because of their presence in underserved areas or just a few more, perhaps none at all? What are the lessons to be learned from the Federal Government's prior involvement in this matter? Why was the old Federal Riot Insurance Program shut down? Was it actuarially sound? Did it meet the needs for which it was created?

I hope all of you will keep these areas focused as we move along. Thank you.

Ms. WATERS. Congressman Gutierrez.

Mr. GUTIERREZ. I would like to thank Mr. Kennedy for having this hearing today and, of course, congratulate you on the piece of legislation that we are about to embark upon.

Yesterday, I mentioned this hearing to an individual from Chicago. This individual's reaction was very positive. She stated that this is the type of assistance the city of Chicago needs.

There are so many areas of my city that have been abandoned by business, and not always unjustifiably. We see it all the time. When the more moderate-income individuals move out of a neighborhood the next thing to go are the shops and small business, businesses that are critical to viability and growth of an area. What we have left are vacant buildings with graffiti and broken windows, which only further contributes to the decline of the neighborhood.

I believe your bill could help rejuvenate these areas, drawing business back in and, in turn, helping our neighborhoods by providing jobs, services, and by providing the building blocks necessary for a sound community.

I look forward to hearing more about the program, and thank you, the chairman, for chairing the meeting and for introducing the legislation.

I had to change this opening statement a bit.

Ms. WATERS. Thank you.

Congressman Sanders.

Mr. SANDERS. Thank you very much, Madam Chairman.

I want to thank you and Chairman Kennedy for holding this important hearing. Your interest in abolishing redlining of the insurance industry has produced laudatory results, and we are making progress on this important issue.

If adopted, Ms. Waters' legislation would provide a solid foundation upon which to build protections against redlining. Ms. Waters' bill, the National Property Reinsurance Act, complements Mr. Kennedy's commendable efforts by diluting the bit of risk that impoverished areas pose to insurers. It promotes the availability and affordability of property insurance in currently redlined areas through a reinsurance program offered by the Federal Insurance Administrator.

The wealthy and the upper middle classes can deposit their earnings in bank accounts insured by the FDIC. Unlike the wealthy, the lower and lower-middle classes cannot safeguard their earnings, and often their livelihoods are tied up in the equity of their homes and other property. We should offer them the same protections we are offering those people who have money.

Ms. Waters' bill provides these safeguards by offering insurance companies a risk-sharing pool similar to that offered the banks by the FDIC. I look forward to working with you and congratulate you on your efforts.

Ms. WATERS. Thank you very much, Congressman Sanders.

We have also been joined by Congresswoman Lucille Roybal-Allard. Please, if you have an opening statement?

Ms. ROYBAL-ALLARD. Thank you very much.

Even in the absence of the chairman I would like to thank him for conducting this hearing on Congresswoman Waters' H.R. 3298 to establish a reinsurance program to make affordable residential

and commercial insurance available in low-income communities. The leadership which has been demonstrated by this subcommittee in highlighting this issue is to be commended.

I share Congresswoman Waters' concerns about the availability of insurance coverage in communities such as those she and I represent. I believe that her proposal to provide voluntary market-based incentives for insurance companies to actively underwrite policies in low-income communities through a reinsurance program deserves our careful consideration and support.

In prior hearings, we have examined the issue of redlining and how those practices negatively impact low-income communities, and I can personally attest to the need for the Federal Government to assume a central role in promoting opportunities for these communities to obtain insurance coverage for home purchases and the establishment of a strong commercial base.

Economic recovery and community revitalization are directly tied to the availability of adequate insurance coverage. Representatives of insurance companies have personally informed me that redlining is a pervasive problem, that the residents of low-income communities are required to pay premiums that bear no relationship to claim rates or actual loss risk to the companies.

Homeowners in affluent communities such as Malibu, California, often pay lower premiums than families in low-income communities. This practice occurs even though the likelihood of loss of those more expensive homes is greater than in a low-income neighborhood.

Congresswoman Waters is to be commended for her willingness to not simply reiterate the issues affecting the availability of insurance coverage but to moving forward and providing an innovative, workable solution to the problem. I look forward to working with her and other members of the subcommittee as we deal with this very critical problem.

Ms. WATERS. Congresswoman Velazquez.

Ms. VELAZQUEZ. Thank you, Ms. Waters.

I want to thank Chairman Kennedy for his continued focus on the critical issue which is the subject of this hearing today.

A special welcome and congratulations to our first witness today, my friend and colleague, Congresswoman Waters.

By introducing H.R. 3298, Congresswoman Waters has again proved herself to be a tireless champion for low-income and minority communities throughout the Nation. The poverty that characterizes these communities has many causes. Among them is the unavailability of insurance, which has been a persistent obstacle to entrepreneurial initiatives and economic revitalization. H.R. 3298 is a sensible, business-oriented response to the unavailability of insurance which should command support from both sides of the aisle.

As I believe Congresswoman Waters herself recognizes, the National Property Reinsurance Act should not be Congress' only answer to insurance redlining. Nevertheless, it is a very important component of what I hope will be an effective and successful campaign against the current two-tiered system of property insurance.

Again, I congratulate Congresswoman Waters and look forward to her testimony and the views and recommendations of our other witnesses today. Thank you.

Ms. WATERS. Thank you very much.

As you know, I was scheduled to really comprise the first panel presenting testimony, and because Congressman Kennedy could not be here I am chairing this subcommittee. But I would like to take a moment to thank him for allowing me to bring this issue before this subcommittee and thus before our committee.

I would also like to thank the chairman in his absence for being willing to take on the hard issues, the kinds of issues that do not readily get discussed in Congress because Members just do not want to deal with the complication of them. Insurance is not easily understood.

I know Mr. Knollenberg is one of those who understands it maybe a little better than most because of his past involvement with it, having served in one of the capacities of the insurance industry in the past. However, again, I just want to say to and about the chairman in his absence that I am very pleased that we are opening up some of these issues in new and different ways. With that, this subcommittee has charted a new course in policymaking.

Under the leadership of our chairman, the Consumer Credit and Insurance Subcommittee has taken a hard look at many problems of low-income America that have traditionally scared legislators. Insurance redlining and availability is one of those tough issues, and that is the subject of my legislation.

Insurance is a primary building block for economic development in this country. Without affordable insurance, private sector development is impossible. In my district of Los Angeles, which includes parts of south central Los Angeles, businesses—especially small businesses—face enormous obstacles in obtaining insurance. We know that many insurance companies, for a variety of reasons, avoid low-income and minority neighborhoods. This practice economically cripples many American communities.

For example, the California insurance commissioner recently charged a San Francisco company with 252 violations of the State's insurance code after he was presented with sworn affidavits by several company employees who presented company maps with lines around certain low-income and minority neighborhoods. The company subsequently agreed to pay a $400,000 fine and undergo reforms designed to increase its market share in underserved areas. The California insurance commissioner has proven legally what many low-income communities dwellers have known by experience for years.

There are other, more benign, demographic and insurance industry trends which contribute to a lack of affordable insurance.

I have written legislation designed to induce insurance companies to do business in underserved areas. Let me underscore this point. H.R. 3298 is an incentive-based, business-oriented approach to the problem of insurance affordability. I think this legislation should appeal to all members of this subcommittee.

The bill we are discussing today does not force companies to insure in areas they may find risky—does not. It attempts to reduce

that perceived risk by allowing companies to sell a portion of that risk to the government.

I believe my legislation very much complements the efforts of this and others in the area of insurance reform. H.R. 3298 is a programmatic response to the crisis we see in so many communities. My bill is not meant to compete with the other congressional initiatives. It would supplement them.

H.R. 3298 embodies a concept which could make an immediate difference in our most economically depressed areas. It is based on previous Federal efforts to increase the availability of insurance. Thus, the FIA has experience with what I am proposing.

These are the central elements of my bill:

The Federal Insurance Administrator. In consultation with State insurance authorities and community groups, would designate areas in each State in which property insurance coverage is not available or affordable for residences or business—not just inner city, not just urban areas, not just suburban areas but in any parts of a State where it needs to be designated. And this, certainly, does include poor, rural communities who find themselves without the ability to get insurance.

The Federal Insurance Administrator would then determine, by regulation, the terms, rates, and appropriate coverage for reinsurance agreements available to pools and companies which operate in these narrowly defined areas. Is it open ended? Can it do anything? That is not so.

The Federal Insurance Administrator would determine, again by regulation, the rates and appropriate coverage for reinsurance, which means that it could be limited, it could be narrowed, it could be defined in ways that are economically feasible.

The FIA would also determine an amount of coverage above which the insurer or pool would resume responsibility for coverage. Therefore, the Federal Government's liability would be strictly limited.

Companies and insurance pools serving such areas would be eligible to enter into agreement with the Federal Insurance Administrator to share or spread a portion of their risk.

The FIA would maintain a revolving fund comprised of the reinsurance premiums paid by the primary insurers. The fund would be the source of payment for the catastrophic coverage which might be required in accordance with the reinsurance agreements, spreading the risks in the most profound way.

Insurance companies would then establish primary insurance rates within the designated areas, which reflect the risk reduction from the reinsurance coverage in the private voluntary marketplace.

This program leaves discretion to the Federal Insurance Administrator to implement through regulation many of the details that would be necessary to run a smooth and efficient program. We believe this flexibility would expedite the process and leaves the proper level of control with those who will operate the program.

I believe there are two primary reasons insurance coverage is as scarce in many low-income communities. First, there is a rational need to insure certain kinds of property at higher rates due to

physical deterioration, concerns over health and safety codes, and differences in the risk of property damage in specific areas.

However, there is another, less rational basis for prohibitively high insurance rates, and that is fear. There is a fear of certain areas of our cities, particularly inner cities and very poor rural communities, a fear of working in low-income areas and a fear of the unknown.

In many cases, this fear is not based on a rational understanding of the business climate that exists within communities. Rates often do not reflect the actual risk or potential loss of many communities.

We have discovered this working with banks and financing institutions that redline that there were many people living within these communities who have substantial income, who have long work histories, who have lived in the community for long periods of time, and they are very stable citizens and residents. And because these institutions redline they miss the opportunity to do business with very substantial potential clients.

So we know by experience and because of CRA and other things we have done banks are finally waking up and discovering that they can indeed do some of that business.

To illustrate what I mean again, the Missouri insurance commissioner recently found that insurers were charging policyholders in low-income minority areas higher premiums than they did policyholders in low-income white areas for comparable policies. This was true even though the losses were higher in the white community. Residents in the minority areas were paying premiums 1½ times those in the white areas for inferior policies, while the loss ratios were 72 percent in the white areas compared to 57 percent in the minority areas.

Why do we have to do this kind of legislation? Why are we now bringing it forward? Take a look at the change of this subcommittee. Take a look at the communities we represent. If we allowed these kinds of practices to continue while we have been elected to serve these communities we wouldn't be worth our salt.

We now have the opportunity to bring new information and a new kind of representation to Congress. While others may not have known about this, while others may not have seen the need to talk about this, it is a new day, and this subcommittee reflects the kind of diversity people are going to have to deal with.

We can't allow those kinds of statistics and that kind of information to be documented and we not stand up and say let's look at this. Let's change it.

I would like to conclude by reading——

Well, before I do that, one of the benefits of legislation like H.R. 3298 would be to induce insurance companies into areas they have avoided and expose them to the right business community. In the long run, we will reduce the fear of many companies, and, ultimately, rates will come down when companies perceive risk.

[The prepared statement of Ms. Waters can be found in the appendix.]

I would like to conclude by reading testimony from a prominent insurer in my community.

Crusader Co., is one of the very few companies to insure in south central Los Angeles—in fact, one of the few to insure and serve

inner-city areas in California. We learned a lot about Crusader insurance following the civil unrest in Los Angeles. And it was made known by the press that Crusader had indeed been in the inner city, and because they were the only ones or one of the very few, they assumed a lot more risk than others.

Mr. Cary Cheldin, Crusader's executive vice president, was invited to testify today. He was unable to attend but submitted the following statement, which I agreed to present to the subcommittee.

He would have said: My name is Cary Cheldin. I have, personally, managed Crusader's underwriting for each of the past 7 years.

Our company provides more insurance service to inner-city merchants than does any other company in the world, relative to size. The vast majority of California's inner-city agents, brokers, and merchants will confirm that we have been an equally active member and supporter of inner-city commerce since the day we started business 9 years ago.

Our underwriting support of inner-city risks had always been profitable—that is until the 1992 civil unrest. As a result of our inner-city support, we sustained losses which threatened our financial survival and depleted more than one-half of our total assets.

Although we are still committed to helping our current and future customers in these underserved areas, we are also bound by economic constraints and by a duty to protect and serve our policyholders and our public ownership.

Generally, the purpose of insurance is to spread the risk of loss so that any one loss will not disrupt our individual or collective economy. Before 1992, Crusader effectively spread the risk through the purchase of reinsurance. However, the 1992 disturbances were the most costly in our Nation's history and were the largest in terms of both geographic extent and financial impact. As a result, the required amount of reinsurance for our same inner-city property risk had increased fivefold.

It is impossible for us to spread so much more risk. Therefore, we see only two, equally unattractive, alternatives: One, drastically reduce the number of our inner-city customers or impose huge rates increases on our inner-city customers.

Our inner-city customers have few other choices. Recognizing that these customers have historically been underserved by the private sector insurance industry, most State laws provide them some form of FAIR plan assistance. However, realistic support and improvement of inner-city commerce can only be achieved with a diverse, voluntary marketplace; that is, a marketplace from which affordable property insurance can be purchased.

These facts were recognized by Congress at one time in 1968 with the establishment of the National Insurance Development Plan. H.R. 3298 would restore important aspects of that plan and provide the mechanism of financial incentive needed to develop and maintain a diverse, voluntary marketplace from which inner-city customers and others throughout the State could buy affordable property insurance.

Without such legislative assistance, I believe that Crusader, like many other businesses, will be forced out of the inner city and other areas that we serve that have been traditionally underserved,

areas that we have found to be otherwise attractive. With such legislation and the affordable reinsurance it offers, we will be able to expand our operations in inner cities and other underserved areas, as will many other insurers.

I regret to report that many, mostly large, insurance companies have not and will not support this kind of legislation. I can only surmise that such disregard reflects either equal disregard for the welfare of certain of our communities or reflects fear that their smaller competitors, such as Crusader, will be successful.

My company and a few other small companies, which still embody the American entrepreneurial spirit, have underwritten inner-city risks for many years and at greater levels of support than have been provided by many large insurers. This legislation would encourage those smaller companies to continue their inner-city support to these kinds of areas.

Furthermore, by assuring access to secure and affordable insurance, H.R. 3298 will eliminate the only logical reason for any insurer to avoid underwriting commercial property risks in inner cities. Thank you. Signed by Cary Cheldin.

[The prepared statement of Mr. Cheldin can be found in the appendix.]

Ms. WATERS. With that, before we can ask our second panel to come forward we also have Congressman Barrett from Wisconsin who just joined us who also has experience with the insurance issues. While the panel is coming forward I would like to ask the Congressman to please join us with an opening statement prior to their testimony.

Mr. BARRETT. Thank you.

I prepared a statement that I will submit for the record, but I want to commend you for the leadership you have shown on this issue. This is an issue near and dear to my heart. I have seen the effects of insurance practices on central city residents in terms of business insurance, homeowners insurance, and automobile insurance. I did a study that showed where automobile rates for an area literally across the street from each other could vary by as much as 90 percent depending on whether you live in the suburbs or the city.

I applaud your leadership on this issue.

[The prepared statement of Mr. Barrett can be found in the appendix.]

Ms. WATERS. I thank you.

I am one of those inner-city residents in Los Angeles on automobile insurance. I pay $2,000 a year to insure a car, and in Washington the same car insures for about $400. So I know what you are talking about.

I am going to depend on you to help me to understand and work on this issue because I think we can empower communities that want desperately to be revitalized and to be economically empowered by making sure that we do everything that we can to provide them the opportunity for insurance.

Thank you very much.

Our panel is now present.

With that, I would like to welcome Elaine McReynolds, our new Federal Insurance Administrator, and thank her for being with us today. Please proceed with your testimony.

STATEMENT OF ELAINE McREYNOLDS, FEDERAL INSURANCE ADMINISTRATOR

Ms. McREYNOLDS. Good morning, ladies and gentlemen. Thank you, Congresswoman Waters, for asking us to appear this morning. I am very pleased to be here. This is my first official congressional hearing since having been sworn in just a few weeks ago.

The subcommittee and the bill's sponsor, Congresswoman Waters, are to be commended for their consideration of the extent to which property insurance is available and affordable in the private insurance market, particularly in the cities and rural areas of the Nation.

Your inquiry into property insurance availability is very timely. We know that in response to homeowners insurance unavailability in Florida and Hawaii, State insurance mechanisms were legislated to fill the void. Florida's joint underwriting association has already grown to the point where there are now about 455,000 homeowners insured under the program.

The fact that there is need is evident. Whether there is a short-term solution that is being sought or whether it is a long-term one, availability—the availability issue—still needs a great deal of exploration. But the situation certainly sends a strong signal to public officials and legislators, as well, that a watchful eye must be cast upon the current state of insurance availability and affordability. You are doing just that in this hearing, and I am proud to be called upon by you to testify.

I must tell you, however, at the outset that we are in the process of reviewing the specific proposals for reinsurance in H.R. 3298 and would like an opportunity to supply written views on this bill at some point in the future.

The issue of reinsurance is very complex and very difficult, especially the pricing aspect with various individual insurers, as compared to the more basic, direct programs of insurance. We will need more time to properly assess all of the ramifications of this bill.

I believe that there may well be insurance market dislocations in some areas being experienced by residential and business property owners. Thus, it may be that the private insurance markets, endemically, are somewhat dysfunctional in certain areas of the country. I would like very much to work with each of you to offer whatever assistance I can in dealing with the insurance problems that may be encountered in individual communities.

I do have what is believed to be a property insurance marketing problem to present for the subcommittee's attention this morning, one that I became very familiar with when I served the State of Tennessee as its commissioner of commerce and insurance and one that I have looked into personally in my short tenure as FEMA's Federal Insurance Administrator. I refer to the availability of the Federal Crime Insurance Program.

The Federal Crime Insurance Program was established by Congress in 1970. It is administered by the Federal Emergency Management Agency through its Federal Insurance Administration,

which is authorized to offer Federal crime insurance in States which have concluded that there exists a critical problem in the availability of crime insurance.

In 1991, 14 States, the District of Columbia, Puerto Rico, and the Virgin Islands were participating in the program. Policies, offered both to individuals and businesses, cover losses due to robbery and burglary.

In 1992, the number of participating jurisdictions was reduced to eight States and the District of Columbia, Puerto Rico, and the Virgin Islands. Three States—Delaware, Rhode Island, and Tennessee—were removed from the Federal Crime Insurance Program effective July 1, 1992, and three others—Alabama, Connecticut, and Georgia—were removed December 1, 1992.

Subsequently, after I intervened as Tennessee's commissioner of commerce and insurance, on June 30, 1993, the State of Tennessee was readmitted into the program.

As of now, there are only 12 jurisdictions in the Federal Crime Insurance Program—California, Florida, Illinois, Kansas, Maryland, New Jersey, New York, Pennsylvania, Tennessee, the District of Columbia, Puerto Rico, and the Virgin Islands.

There are 16,625 policies in force, of which 13,855 insure residences and 2,770 insure businesses against crimes of robbery and burglary. The total insurance coverage in force is over $151 million.

In 1980, in contrast, there were 26 States and other jurisdictions in the Federal Crime Insurance Program in which 62,544 residential property owners and 20,619 commercial property owners were insured. Thus, through the decade of the 1980's and during the last few years, the Federal Crime Insurance Program has shrunk to its current state through, I believe, lack of a vigorous marketing program and some serious flaws in its operations.

We have taken a hard look at the marketing efforts on behalf of the program for the past dozen years or so and found that these were virtually nonexistent. Indeed, previously, a preference had been expressed for the termination of the Federal Crime Insurance Program, after it had become downsized and almost moribund, on the grounds that only a few States were eligible for the program.

Looking at the operation of the program, it is apparent that the Federal Crime Insurance Program was made available in States which acknowledged that they had a critical crime insurance availability problem. Crime insurance was not made available on a city-by-city basis or in other areas in the State underserved by the market forces unless the State itself came into the program.

Some other concerns with the program need to be addressed, such as accessibility of insurance, the administrative process under which States become eligible and the program's insurance policy conditions as compared to what is available in the private sector.

Crime insurance unavailability is still a problem in many States. My own State of Tennessee is an example. So is the State of Washington, which asked for reentry into the program in 1991. The territory of Puerto Rico, which is experiencing great increases in crime, has recently asked for an increased marketing effort there.

Last December, Congressmen LaFalce and Charles Schumer of New York held hearings in Buffalo, New York, on the plight of the small business owners in the Nation who are faced with high crime

rates and unavailability of crime insurance. They cited a report on the subject concerning a community of small businesses in Columbus, Ohio, and I hope to obtain and review that report. Interestingly, Ohio is one of the eight States that left the Federal Crime Insurance Program in the mid-1980's to set up its own crime insurance program.

A serious and sustained marketing effort for Federal crime insurance can help residential and small business property owners attain the affordable insurance they deserve.

We are looking at our policy forms, rates, underwriting rules, and available coverage to present the most attractive, yet cost-effective, program that we can to our consumers. If it turns out that we have overestimated the market to the extent, that will provide—to that extent, too, will provide valuable insights.

Returning to House bill 3298, the effort we are undertaking in the Federal Crime Insurance Program—State by State, market by market—may be an approach meriting consideration for other serious insurance market unavailability problems on an individual line of insurance basis, rather than on an all standard lines, countrywide basis.

I hope these thoughts will be of assistance in the fine work you are engaged in. Once we have a chance to thoroughly review the bill with the administration we will be pleased to provide you with additional thoughts and observations. I look forward to the opportunity to work with each of you on the subcommittee and would offer the resources of our office to you.

At this time I would be pleased to respond to any questions you have, Ms. Waters, or other members of the subcommittee.

[The prepared statement of Ms. McReynolds can be found in the appendix.]

Ms. WATERS. If you can remain with us, we will have questions.

But I would like to move to our second panelist, Mr. Franklin Nutter, who is the president of Reinsurance Association of America.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Thank you very much, Madam Chairwoman, members of the panel.

I am Frank Nutter, president of the Reinsurance Association of America. The association represents property casualty reinsurance companies. These are companies that insure other insurance companies. Reinsurance companies do not deal directly with the public but instead provide insurance protection for insurance companies.

We, too, commend the subcommittee for its study and analysis of the problems of insurance availability and affordability in underserved areas. While we appear today in opposition to the legislation which you have sponsored, we do think that it is an important and critical issue, and you have our commitment to work with the subcommittee to see it is properly understood and proper solutions are devised.

Reinsurance is, basically, the function of spreading risk throughout national and international insurance markets. It provides a means to minimize the fluctuations in the underwriting cycle that insurance companies have. It protects against catastrophic expo-

sures that insurance companies take on in their policyholder base. And it allows companies to write business that their capital base might not otherwise allow them to write.

What it is not, however, is a substitute for risk diversification among the underlying company's base or sound financial management of the company.

We oppose the legislation or believe that it is not appropriate for three reasons. First is that the legislation appears to be predicated upon the assumption that there is a market failure or market deficiency in the private reinsurance market. We do not think that that exists.

In fact, Madam Chairwoman, when you introduced the legislation and in preparation for this hearing, I contacted a number of our member companies to find out if they were routinely providing property reinsurance protection for companies writing inner-city risk among their book of business and particularly to focus on riot or civil commotion and found that the companies were routinely including that coverage in their private reinsurance contracts.

That analysis is consistent with a survey conducted by the National Association of Insurance Commissioners in the fall of 1992 where the NAIC surveyed all of the State insurance commissioners on a variety of issues related to urban insurance availability. Two of the questions related to reinsurance.

The questions were basically whether or not the regulator had any indication that reinsurers were reacting to the Los Angeles riots in their pricing or coverage practices or whether the regulators had received any complaints about cancellation or nonrenewals on reinsurance coverage. Forty-one commissioners responded to that, and 40 answered no, that there were no problems in the reinsurance markets.

Our assessment is that coverage is readily available for property risk at affordable prices. Indeed, individual insurance companies' circumstances may necessitate variances in rates that reflect their underlying policyholder base or their loss experience, but that is the nature of an insurance or reinsurance program, whether a government or private sector one.

It also seems to us that FAIR plans, which operate in 29 States and were created as a result of civil disturbances in the late 1960's, have been part of the solution with regard to insurance availability in the inner cities. We would encourage the subcommittee to look at the experience of the FAIR plans to determine if, in fact, they are serving properly to maintain and provide property insurance markets for underserved areas.

The second reason that we feel that the legislation is not appropriate is that, in fact, there is a prototype, the Federal Riot Reinsurance Program, which operated from 1969 to 1983 when Congress decided not to reauthorize the program. I encourage the subcommittee to ask the Federal Insurance Administration for a report looking at the experience of the Riot Reinsurance Program as to the premiums collected, the losses paid, and whether or not it served the purpose that it was designed to provide at the time. And to see whether or not it is, in fact, a prototype for the solutions that you are looking for, for the current problems in the urban areas.

The third reason that we believe the legislation is not appropriate is that we really don't think that it will work. The bill's goal, as stated by several members of the subcommittee, appears primarily to encourage insurers to write property coverage in the Nation's inner cities. There appears to exist no significant relationship between insurers' ability to provide urban property insurance coverage and the availability of reinsurance.

Reinsurance only reflects the underlying risk assumed by the insurer. Unless the government or a government program can reduce losses associated with urban risk or unless a government program would subsidize the reinsurance rates, it appears that a Federal mechanism that competes with an active private reinsurance market would have little or no effect on the ability of insurers to provide additional inner-city coverage or reduce insurance prices to policyholders, particularly if the legislation requires actuarial sound rates, which it does.

In conclusion, we encourage the subcommittee to defer any action on the legislation until there is additional analysis. Both the insurance commissioners that are conducting a comprehensive data call among insurance companies and the States are looking at the problems of urban insurance availability. The Congress itself appears to be poised to pass legislation designed to collect additional information that should shed light on the problems of insurance availability.

We think that at the conclusion of that analysis that the problems will be clear and the solutions that would be appropriate in the private sector or in the public sector will be clearer as well.

Thank you very much. You certainly have our commitment to continue to work with you.

Ms. WATERS. Thank you very much, Mr. Nutter.

I am going to ask your indulgence while we go vote. A quorum call—they will check on that. I wanted to not have you start your testimony and then interrupt you. Let our staffs check to see exactly what we are supposed to be doing at this moment. We can't read the lights.

We will continue. Thank you, Mr. Nutter.

[The prepared statement of Mr. Nutter can be found in the appendix.]

Ms. WATERS. Miss Whitehead, president of Economic Empowerment Foundation in Oakland, California.

STATEMENT OF SELWYN WHITEHEAD, PRESIDENT, ECONOMIC EMPOWERMENT FOUNDATION

Ms. WHITEHEAD. Thank you very much, Ms. Waters, for inviting me here.

I am Selwyn Whitehead. I am the president of the Economic Empowerment Foundation in Oakland, California. The foundation is a nonprofit, nonlobbying corporation that is determined to bring about the small business development and expansion and home ownership financial and technical assistance resources back into historically underserved communities. These resources are necessary for those of us who live in these communities to create economic wealth and stability and spur on the revitalization of our communities.

We really focus on helping small business people expand their businesses, first-time homeowners get into a home, and community based small businesses and microbusinesses to grow and prosper.

The foundation also strives to shine the media's light on political and regulatory bodies that have abdicated their responsibility to compel banks, insurance companies, and other financial institutions to perform their capital formation and other financial product access functions in a nondiscriminatory manner.

I want to take this opportunity to thank Ms. Waters for drafting H.R. 3298 and Mr. Kennedy for having these hearings and affording me this opportunity to discuss the merits of the bill and explain why I believe it is a necessary component in an overall strategy for making product insurance more accessible, affordable, and available in historically underserved communities like Ms. Waters' south central Los Angeles and my home of East Oakland.

I must inform you that the low- to moderate-income and of-color residents and business owners in our urban communities urgently need Congress to establish oversight regulation and legislation which first establishes a mechanism for collecting information about the affordability, availability, and accessibility of insurance products and investments along with the underwriting processes that the insurance industry uses in our communities and then take the next step, which we believe that this bill will do, and that is, provide incentives.

There also is a need for penalties, but I think that should be reserved for another hearing.

I want to go into the questions that Mr. Kennedy asked in his letter when he invited me to attend. The first was, would a greater availability or access to reinsurance coverage encourage insurers to return to historically underserved inner-city areas? My answer in a word is "yes."

I believe that the lack of adequate reinsurance in both the voluntary and residual markets could lead to future economic—further economic deterioration of Los Angeles and East Oakland and other urban areas. Without adequate reinsurance to protect themselves against catastrophic risk, insurance companies will presumably withdraw even more of their capital from urban areas. Without the availability of commercial property insurance, private investors and credit lending agencies will not be able to provide loans for home ownership and businesses that our communities so desperately need.

Let me be more blunt, as I am known to be. I have been informed by insiders in the insurance industry that reinsurers have the stated belief that communities of color will, because of some inherent moral or economic deficiency, periodically destroy themselves. As such, they are not believed to be a good risk for reinsurance or primary insurance.

It is my understanding that this false belief is based on the actuarially unsound basis of observing and trending the 15 or so race riots that have occurred in black communities in the United States over the last 300 years.

I put that in there. I did not want to bore you with my credentials but to let you know I know a little bit about insurance. I happen to be a consumer representative on the California automobile

assigned risk plan. I have been on the Actuarial Ratemaking Committee for the last 3 years. I also intervened in several rate applications before the State.

And I must tell you, unfortunately, I am the only African-American funded consumer rep to the National Association of Insurance Commissioners, where I participate on the Affordability and Availability Committee, the Model Investment Law Committee. And, of late, I have been involved in health care insurance because there needs to be representation by people that look like me on these very important policymaking bodies.

So I do know just a little bit about actuarial issues—not so much that I have that knowledge myself but the foundation has four actuaries that consult with us and help us in our analysis of rates in California.

So I do believe that 15 to 20 or so incidents over 300 years is not an appropriate body of observations to make this kind of unactuarially sound justification.

I must add that the reinsurance industry, much like Fannie Mae and Freddie Mac in the lending industry, are the secondary markets for insurers, allowing insurers not only to spread the risk, as my colleague on the panel stated, but also to recycle their surplus and thereby increase their incomes by selling more product and making more investment income. As such, like Fannie Mae and Freddie Mac have enormous control over the kind, quality, and quantity of loans made to certain classes of borrowers, so, too, does the reinsurance industry exert enormous control over where and to whom insurers book business. Unfortunately, because insurers and reinsurance have been so closely linked for so long, the pathologies that one might share have been shared to primary insurance as well.

H.R. 3298 will allow a knowledgeable market-motivated insurer to increase its market share while serving our community. Unfortunately, little can be done for the ones that tend to want to retain what I call the brain-dead kind of tactics of the past. Fortunately, I believe we only need a few takers initially, because they will succeed in opening up a marketplace and making money, and the greed motive will bring the rest of the insurers around.

The second question was, what level or mechanism of reinsurance incentive would encourage insurers to resume insuring in the inner city? Because we are dealing with pathology, and that is what I call racism, it is very hard to find an incentive to combat it. However, what H.R. 3298 can do is offer a sincere market-motivated insurer a measure of protection as we learn about our community and finding good markets and more bucks for their bottom line.

Number three, what are the benefits of H.R. 3298 not addressed by the current Federal Crime Insurance Program?

I understand that Federal Crime Insurance Program offers but one mechanism, excess of loss crime protection, and limited protection at that, only 1 to 10K of residential property, with a 5-percent deductible and $500 aggregate limit for most things of value. On the commercial side, the coverage offered is only 1 to 15K.

To my way of thinking, that is not very much coverage. We certainly need more coverage than that.

Number four, how would H.R. 3298 affect the affordability and availability of commercial and property insurance?

As I outlined in part four of my written statement, reinsurance is but an array of mechanisms that can lead to the revitalization of historically underserved communities. The others include increased product access and more appropriate risk-based pricing through community-based agency appointments and more and varied community and industry wealth-creating investments in the urban core. Also, more contact between primary insurers and communities like mine.

More importantly, if Congress is prepared to bail out the insurance industry for its mismanagement and over underwriting in communities prone to identifiable, foreseeable natural disasters such as hurricanes and earthquakes in white upper income communities via the National Disaster Mitigation, Relief and Insurance Act of 1993, does not Congress have a duty to protect consumers in the urban core who suffer the effect of unnatural disasters based on racist, sexist, and classist underwriting criteria?

I will conclude by saying the only fault I find with the bill is section 1225(c). That is called National Property Reinsurance Fund, Investments. You limit the investment of the surplus to only U.S. obligations.

I have attached at appendix A my argument that all entities involved in the management of insurance portfolios should diversify their investments throughout the entire economy, including investments in historically underserved communities in all small businesses.

I had a few comments about what I perceived to be some of the arguments against the bill, but I don't want to overspeak my time and might leave that for questions and answers, if you would prefer.

[The prepared statement of Ms. Whitehead can be found in the appendix.]

Ms. WATERS. Thank you very much, Ms. Whitehead.

I think there are some questions. Let me start with Mr. Knollenberg.

Mr. KNOLLENBERG. Thank you very much. I appreciate the testimony of everybody.

One observation—we are hearing a lot about the primary market, and I understand that may be a problem in a given State. In my home State of Michigan I don't think it is near the problem I hear it may be in other States.

The focus of this bill, I believe, is reinsurance. If I read the very top of the communication, it is called the National Property Reinsurance Act. In my questions to the panel, I am going to focus on that. Reinsurance is an issue that I know is of concern to a great number of people.

I have a question that could be answered by maybe a couple of you, Mr. Nutter or Ms. McReynolds: I will go back to the Federal Riot Insurance Program, which, by the way, was passed over but was not authorized beyond 1983. That was, I believe, initiated in 1968 or thereabouts, is that right? Can you tell me why was the reinsurance program not reauthorized, Mr. Nutter?

Mr. NUTTER. It would be somewhat speculation on my part as to what the thinking of Congress was at the time, but I know that the debate centered around the experience of the program. Something in the neighborhood of $140 million I believe was collected and invested or interest earned and invested. The amount of claims were something under $15 million over the entire period of the program.

It appears that the program did not have much of an effect either in supplying a needed commodity, that is, reinsurance protection, or that it proved that there was no particular linkage between having the Riot Reinsurance Program and the availability or affordability of insurance in the inner cities.

In preparation for the hearing, I reviewed testimony provided by the insurance commissioners at the time the debate was going on in 1980. They commented, related to the Riot Reinsurance Program, this analysis leads the NAIC to conclude that the availability of riot reinsurance under the UPPRA, which I presume is an acronym for the legislation, is not a significant factor in encouraging the insurance industry to provide essential property insurance coverage to inner-city markets.

That certainly is consistent with our view that, in fact, a Federal reinsurance, particularly a riot reinsurance, program is not going to have much of an effect on those property markets. That the problems are, in fact, underlying in terms of the commercial and residential insurance markets in those cities and that there may indeed be local or parochial kinds of problems and issues that need to be addressed, that it is not a national problem in that sense.

Mr. KNOLLENBERG. You stated I think that—in your testimony that the—what happened—you mentioned that the Federal Crime Insurance Program rated—I think that was the term that you used—the Federal Riot Insurance Program's premiums. There must have been a surplus. What happened to that money?

Mr. NUTTER. As I understand it—and I suspect Ms. McReynolds, being new, is not able to respond in detail, but perhaps the Federal Insurance Administration can get back to the subcommittee with more information—I know that at the time that the reserves held by the Riot Reinsurance Program, $140 million, was appropriated by the agency to meet a deficit in the Crime Insurance Program. So, in fact, there were no reserves in the Riot Reinsurance Program when it was finally sunset. There was no money built up to pay claims.

I presume there was a mechanism to meet any liquidity problems that it had. The Federal Riot Reinsurance Program, having been successful from the government's point of view, was used to subsidize the Crime Insurance Program at the time.

Mr. KNOLLENBERG. Do you want to comment, too?

Ms. MCREYNOLDS. Obviously, all of that was pre-me.

Mr. KNOLLENBERG. You have been on the job 3 weeks?

Ms. MCREYNOLDS. James Lee Witt swore me in on April 20.

Our testimony, obviously, did not deal a great deal with reinsurance, and the reason for that is because the administration is deciding what its position is on the Federal involvement in reinsurance programs in general. And for that reason—I don't mean to be

skating here, avoiding direct answers to your questions, but I just don't have an administration position just yet.

Mr. KNOLLENBERG. Is it suggested maybe then that the reason it wasn't reauthorized, the Federal Riot Program, is because some of the programs that are in existence in California in particular and across the country picked up that slack and provided that riot coverage? I understand the FAIR plan in California does include riot coverage. Is that true?

Mr. NUTTER. I think that is accurate. Ms. McReynolds may not be familiar since she was the commissioner in Tennessee.

Mr. KNOLLENBERG. So there was riot coverage in effect in 1992 during that timeframe.

I noticed Ms. Waters referred to the Crusader Co. I understand that that company is a California-based company, has admittance in six States but does business only in California, and I get the impression that maybe it is doing its business only in the L.A. area. Maybe it was limited to one little pocket which doesn't create any way of avoiding some of the terrible losses they had in 1992.

I want to come back to this comment about this. The reason maybe—and I am going to ask your views on this—perhaps why the Federal Riot Insurance Act wasn't reauthorized and perhaps why there hasn't been a call for it is because somehow the private market system has picked up that slack, has provided coverage in the wake of that particular feature, that particular bill and that particular program not being needed.

Would either of you, Mr. Nutter or Ms. McReynolds, want to comment on that? Why don't we have a crying need for this kind of coverage in that interim period—in that interim from 1983 until 1994? Are private programs doing the job? Is the FAIR Program doing the job? What is picking up the slack?

Ms. MCREYNOLDS. There are only about 29 States that have FAIR Programs, so we are probably not going to get conclusions that are consistent from one State to another as to the answer to your question. And it is in two parts—what the primary market is doing and then what the reinsurance market is doing.

I am very much looking forward to the data that is to be gathered by two pieces of legislation that are working their way through Congress right now on the issue of availability of insurance in many of the underserved areas. And I think, based on what I am told, that that data might provide some insight into where the real availability problems are with regard to the primary market and the reinsurance area.

But, at this point, the Federal Insurance Administration does not have any concrete data on which I could respond to that question.

Mr. KNOLLENBERG. If you do collect some could you make us aware of that? Could you communicate with me?

Ms. MCREYNOLDS. Most definitely. I would be pleased to do that.

Mr. KNOLLENBERG. Would you comment, Mr. Nutter?

Mr. NUTTER. Our position is very clear. Even during the experience of the 1970's and 1980's when the Federal Riot Reinsurance Program was in place, it had a declining base of companies purchasing it because there was an affordable and available private reinsurance market for the companies. I believe in 1993 that there

were just 17 insurers that were purchasing the Federal riot reinsurance and that the premium base was something like $130,000.

The program declined, I think, because of an available private market. You are suggesting that the FAIR plans, which were not in effect in 1968 when the Riot Reinsurance Program was put into effect, began to take over some of the problems and deal with some of the problems of inner-city insurance availability. It may be that they deserve some examination now to see if they continue to fill that role, but, in fact, the FAIR plans seem to have been effective in dealing with the problems that were evident in the early 1960's and 1970's and perhaps are evident again in the 1990's.

Mr. KNOLLENBERG. You think that there is in the urban market, via the private market, a pretty substantial array of products that are available to meet the needs?

Mr. NUTTER. Well, certainly, the standard commercial insurance coverages and the coverages provided by the FAIR plan cover civil disturbance, riot, that kind of thing, the sort of thing that is of concern both to the citizens who live there as well as to the commercial enterprises who do business there, including the insurance industry. The reinsurance markets provide reinsurance protection for that, including the FAIR plan exposures as well as private commercial coverage.

Even the Crusader Insurance Co., had a reinsurer in the private market. The reinsurance paid reinsurance claims as a result of their experience in the L.A. riots.

That reinsurance program is still in effect. It was not canceled, to my knowledge, or modified. Mr. Cheldin, apparently, is concerned about the price of that reinsurance protection.

Ms. WATERS. That is no little concern. Availability really has to do with pricing. If his insurance increased 5 percent let us not pretend that somehow that doesn't have anything to do with availability.

Let's just kind of tell the whole story. Did you find out that, yes, that insurance is available at a price, but it is prohibitive?

Mr. NUTTER. I don't know whether it is prohibitive or not.

Ms. WATERS. Is it five times what it was.

Mr. KNOLLENBERG. Can I interject something? We are talking about reinsurance, not a price. We are talking about reinsurance.

Ms. WATERS. This is reinsurance.

Mr. KNOLLENBERG. Let me respond in this way. I just picked up something that indicates to me that, based upon some of the pressure and conversation and talk as to what has taken place in California, that Farmers Insurance Co., has targeted California and the inner cities in an effort to meet some of those needs.

I can't offer anything to you specific about pricing because I haven't seen any of this and it is too new. I can just read to you what they are trying to do is—it is a program by the Farmers Insurance Co. It is called FACT [Farmers Action for Communities of Tomorrow], and it is an effort to do just that, offer coverage to the inner cities, particularly those that were involved in the riots, inner-city residents, businesses, what have you. This program is just coming on line because Commissioner Garamendi, I think, was probably the individual that had most to do with some of the changes legislatively that have occurred in California.

It is an effort I think—and certainly I would be more than happy to submit this into the record—to indicate that there is an effort being made to deal with those problems. It is very new, hasn't hit the streets yet, but it is in the planning stage. I wanted to focus on the reinsurance aspect of this and try to deal with that.

In conclusion, I might come back with another question later, but I wanted to gather, if I could, from Mr. Nutter—I apologize that you have just been on the job 3 weeks. I would hate to have your role today in terms of what we are throwing at you here.

But you made a statement, I think, Mr. Nutter, that reinsurance for riot or other urban risk is widely available in the common market. You don't discuss price, but you are saying that there are a number of offerings available for the purpose of buying coverage. A person may object on the basis of price, but you are saying, I believe—and I am not trying to put words in your mouth—that there are products out there, if people choose, that want the coverage?

Mr. NUTTER. Certainly, the answer to that question is yes. It is my understanding, on hardly a sophisticated survey but in contacting some of our companies, that there do not appear to be any widespread problems with regard to the price of reinsurance for riot, civil commotion kinds of coverage.

Obviously, that is a function in the private sector just as it would be with a Federal program. If you are going to use actuarial basis for the rates that reinsurancers charge, it is going to be a function of what the company has by way of its policyholder base, its loss experience, and the premiums that it charges for that. So the private sector has the same kind of problems that the public sector would have in providing a reinsurance program and looking at each company on a company-by-company basis, to look at its policyholder base and its loss experience.

Mr. KNOLLENBERG. Thank you.

Ms. WATERS. Thank you very much. Would you like to submit that article for the record?

Mr. KNOLLENBERG. I would.

Ms. WATERS. Please do that.

I know Farmers quite well. I was a legislator for 14 years, and they know me quite well.

Mr. Barrett.

Mr. BARRETT. Thank you.

I want to concentrate on the reinsurance industry, too, maybe from a little different angle, and I look at the problems of the central cities in particular and try to figure out what is the best way to provide capital and have private investment in those communities. Time and time again, we are told we don't want the government to do it. That means we either don't do it or the private sector does it.

I look at your statement, Mr. Nutter, and I appreciate your comments that you are willing to work with the subcommittee here, and I wonder whether—I certainly accept your statement that there is not a problem in the availability of reinsurance in these geographic areas, but I wonder whether the reason that there is not a problem with availability is that there is simply no demand for that.

Mr. NUTTER. That is an interesting question. I think my understanding of the market and the contract coverage is that it is routinely included in insurance contracts covering commercial as well as residential exposures, inner city or not, and that it is routinely included as coverage in reinsurance contracts, that it is not a question of demand because it is a standard part of reinsurance contracts, and there are no real exclusions for it.

Mr. BARRETT. But if the primary market is failing and there is no insurance being offered on the market, you would never see that problem. That is why, when the question goes out to 41 insurance commissioners as to whether there is a problem with reinsurance, if there is no primary insurance market there certainly would not be any reinsurance problem.

Mr. NUTTER. There is no question that reinsurance is the insurance of insurance companies. If the insurance company is not providing a certain type of coverage, whatever that may be, then it is not a question of whether reinsurance is there or not.

The survey that I referred to that the NAIC, the insurance commissioners, conducted was a much more comprehensive survey. And there were only two questions dealing with reinsurance.

I would encourage the subcommittee to solicit that information from the NAIC as well as information related to the data call that they are doing to actually do some objective analysis of the problems with availability in underserved areas. I think that will show a lot about whether the problem is at the insurance level in terms of available and affordable markets or whether it is a reinsurance problem.

Certainly, the initial survey would suggest that the commissioners did not feel that the problem was either driven by or caused in any way by the availability or affordability of reinsurance.

Mr. BARRETT. I don't think they would ever be driven by the availability of reinsurance, but I believe that if there is no primary market for insurance there would never be a problem in the reinsurance market. So I think if we are trying to zero in on the problem certainly we have to look at reinsurance.

But I think what Congresswoman Waters is trying to do is trying to figure out a way to create a primary insurance market, and one way to do that is perhaps by—to look at incentives in the reinsurance market as well.

Does your association support either of the bills, either the Cardiss Collins bill or the Joe Kennedy bill on the insurance reforms?

Mr. NUTTER. We have supported the Cardiss Collins bill.

Mr. BARRETT. You will get your reward in heaven. That is good to hear.

Seriously, I think it is important that we have the information. Maybe we can get the information from you as to the distribution of reinsurance, because, to me, that is the bottom line, if the insurance is out there and to see what the demand is as well.

I have no other questions other than a comment for Ms. Whitehead. I am mesmerized by your ability to read from that screen. I don't know how that thing kept moving, but it was interesting watching you.

Ms. WATERS. Thank you very much.

Mr. Nutter, are you in favor of the disaster reinsurance legislation that is being considered?

Mr. NUTTER. Yes. Our association supports the Natural Disaster Protection Act.

Ms. WATERS. Could you explain why you think that is necessary as opposed to why this kind of legislation that you do not feel is necessary?

Mr. NUTTER. You can see by these two positions that we are not ideologically opposed to a government role in the reinsurance market if there is a deficiency or failure in the market or an inability of a market to serve a market.

The Natural Disaster Protection Act provides for an excess catastrophe reinsurance program. It is a program that would operate over and above the private reinsurance market. It would be a supplement to the private reinsurance market. It is principally designed to deal with the potential financial problems associated with a truly megacatastrophic kind of natural disaster that might have the effect of making insurance not available in markets after such an event, either in the affected area or in other parts of the country.

Our concern with this legislation is that it appears to be directly competitive with the private reinsurance market——

Ms. WATERS. You used those words for the first time, and I think I am beginning to see this issue of competition is a concern. Explain to me how this would create competition for the reinsurance market?

Mr. NUTTER. It appears to set up a program that would offer property reinsurance protection that, as I have testified and I think the analysis will show, is readily available and affordable in the private market. It would appear to me to be not necessary to create a government program to do that which is available in the private market.

The Natural Disaster Protection Act is written to be effective only in the face of a truly megacatastrophe that would appear to exceed the resources of not just the reinsurance market but the insurance market as well.

Ms. WATERS. OK. Let me ask you, would you agree that—I want to get at this conclusion that you have reached that the lack of available insurance in certain areas has nothing to do with the availability of reinsurance. And you have indicated that there is a study or studies that show that there is no connection, that for insurance companies who want to do business, that indeed the reinsurance is available. And you also basically, conclude that price has nothing to do with whether or not they avail themselves of it.

Would you please describe that study and indicate what you know about pricing that will help us to understand why pricing would have nothing to do with availability?

Mr. NUTTER. Madam Chair, I am not sure you have properly characterized my comments.

Ms. WATERS. Would you reframe it?

Mr. NUTTER. My comment was that there does not appear to be significant linkage between the availability or affordability of pri-

vate reinsurance and the availability and affordability of insurance for inner-city risk, commercial, or residential.

I think, in response to the comment that you did make earlier about price, you asked about Crusader having its price go up five times, whether that was significant. I would not want to imply that the price of reinsurance was not a factor in whether or not a company had reinsurance and, therefore, felt secure in writing urban risk.

My point was this: That it is really the underlying insurance, the cost of that insurance and availability of that insurance that would seem to me to be at issue, and the reinsurance market has generally not been a deterrent to companies going into inner-city markets, that they really are there to protect against catastrophic exposures.

If I used the word "study" I did not mean to imply anything more than the fact that I did a survey of some of our companies, the insurance commissioners did a survey of insurance regulators—it is not a hard data study. And either Mr. Kennedy's bill or Ms. Collins' bill will provide data that I think will shed light for all of us on the problems here.

I think the NAIC's activities in looking at the data will do the same. If there are studies, those are the studies that I think will be very enlightening for us.

Ms. WATERS. Would you agree that, increasingly, insurance companies are not located in inner-city areas and certainly rural communities and that they try to track where they think their potential markets are and that certain suburban areas, and so forth, began to look more attractive and they could offer more preferred kinds of insurance policies? Would you agree that that has been the case, that you could track that kind of movement of insurance companies in America?

Mr. NUTTER. Madam Chair, I would not be in a position to answer the question of whether or not companies focus their writings in certain areas or avoid certain areas. I would encourage you to ask——

Ms. WATERS. That is not what I asked you. I asked, are you familiar with the trend of insurance companies to track their markets and not to be located in or seeking out those inner-city or rural markets but rather to move to areas that appear to be more attractive? With what you know about studies and data and information, would you—could you comment on that at all?

Mr. NUTTER. At the risk of sounding as if I am avoiding your question, I am not familiar with that, and I don't mean that to suggest that it is an accurate or inaccurate statement. I would strongly encourage urge you to direct the question to the primary industry, to the companies that write directly to the public as well as to look toward the studies by the NAIC and the Congress itself to examine that very question.

Ms. WATERS. All right. Let me continue by asking you, do you understand that this legislation is not the old riot reinsurance legislation and it is not the crime protection legislation? Do you understand that?

Mr. NUTTER. Absolutely.

Ms. WATERS. Because everyone keeps referring to riots. Do you understand that indeed in the old insurance that they did have some surpluses that covered the cost of the crime insurance? They did pick up those costs. I think it was in the neighborhood of $130 million or so.

So that we can straighten this out, do you understand that this legislation is a little bit more comprehensive and all encompassing, attempting to talk about underserved areas rather than simply riot or simply crime? That what we are basically saying is that there is a problem in America? There are underserved areas. Do you believe that? That there are underserved areas?

Mr. NUTTER. I would accept the statements by those who are more familiar, including yourself, that there are problems of insurance availability or affordability in inner-cities or underserved areas.

Ms. WATERS. So we agree that there are underserved areas in America, and we are attempting to do something about that. And those problems that created the underserved areas we believe are multifaceted, that you certainly have the risk considerations that companies give.

We think that the data may be a little faulty because you can only determine risk based on experience, and you don't have a lot of experience data in some of these areas because, absolutely, the policies have not been available there. So I think all we need is to get on the same track here, at least in what we are discussing.

So if, in fact, there are underserved areas, the product has not been available, it has not been available for a number of reasons, looking to the markets that appear to be more attractive, maybe the cost of reinsurance being high because the experience data has or has not been there, or it might indicate that they should charge three to five times more, all of that—what we are saying with this legislation is that, whether you are in an inner-city or rural America, that communities die without investment and insurance and that government may have a legitimate role to play in saying to the business community and the insurance community, we understand that there are some risks or something is wrong here, and we want to help out.

We are not in competition with anybody. We create a pool where people pay into that pool, and government may place some money into that pool. We want businesses to thrive.

We want to help show you that you can go in there and do business and make some money in doing business and that, since these markets are not being served in any real and substantial way, we are not in competition with anybody. We are not taking away any reinsurance business because they aren't doing it anyway. We want to create this opportunity for the primary insurance companies to go in there with this reinsurance and do what we think must be done in order to revitalize these communities.

Investors won't go in there. And government is trying to say that we want to do economic development. We want to support small businesses. We want to increase entrepreneurship opportunities. We want to revitalize areas.

And instead of us talking about how we take some line item in the budget and try and find millions of dollars, let's get at the root

causes. Let's say to investors, your investment is safe because it is insured, and the insurers have the reinsurance.

We see and we understand the direct connection. We are saying this bill brings it all into focus. This bill is not simply we want to take the little niche and say if you have some crime, we have a government program; if there is a riot, we have got a riot program.

We are saying there are underserved areas. We are saying to the commissioner help us to identify what these areas are and help us to design and set up products to serve it.

Do you understand what I am saying?

Mr. NUTTER. I understand exactly.

Ms. WATERS. Are there any other questions?

Ms. WHITEHEAD. May I make a comment? I have been sitting here champing at the bit.

I have been hearing statements which offend me. Because I have been dealing with the insurance industry now like 24 hours a day for the last 5 years, I have learned to listen to these words and not be so passionate about it.

But to have—sir, if where you live and where your parents raised you and where you raised your kids characterized as having a need for only a couple of kind of products, I don't think you would like that. I live in East Oakland and we need more than crime insurance and riot insurance.

When I first got involved in the insurance industry only one insurance industry company would even bother to come and look at our community and see how viable and how attractive it is and how diverse our population is, how really neat the old and young people are who were there. They reached out and saw what we were like and saw that we were people.

What we did was bend over backward to clean up the crime in East Oakland. Our crime stats have gone way down. And I swear to you, sir, there has never been a riot in Oakland, but there is a perception in the insurance industry's mind that if a community has a large population of black or brown people or families headed by females that are not married, there is a red flag.

This map that was in this report about the natural disaster and of where the primary—there should be red circles in every urban core because that is an unnatural natural disaster that impacts the entire economy and impacts not only where I live but where you live. Because the insurance industry won't make primary insurance available where I need it in order to attract business people to come in and employ my son and his peers.

Communities such as East Oakland where there was a fire storm, they are paying too much for insurance.

Now the insurance industry is starting what they are calling a managed growth program in California, of which farmers are part of it, where they are not going to write products anymore even to white middle-income consumers because they want to escape the marketplace. That is bad economics not only for East Oakland but for Northeast Oakland.

If I can share with you anything, please open up your minds and realize that just because there is a large concentration of black or brown people, we don't just have little segments of needs. We have the same needs as any other community. We need access to capital,

credit, insurance, grocery stores, and street sweepers. We need good schools. And we know that we are responsible for creating that ourselves, but we need access to the capitalistic system in order to do that successfully.

I wish we would turn this debate from segmentizing it to looking at overall needs of not only my community but yours, because we are intertwined.

It is sort of like the movie "The Defiant Ones," Tony Curtis and Sidney Poitier. We are going to go up or down together. And unless we get the insurance back in my community and my community learns about insurance, we are not going anywhere.

Mr. KNOLLENBERG. I think you were talking to me. I don't disrespect anything you say at all, but I am trying to focus on the real issue here today which is reinsurance.

I think we get into areas that are matters of concern for you and for Ms. Waters. I think I have a rifle, not a shotgun, today. I want to focus on reinsurance, and I think that is the message here. We have to deal with the issue of Ms. Waters' bill, what it extends to.

And I didn't want to give you the impression that I have a hard heart about those matters. I served in the metropolitan area of Detroit, and I had a great deal of customers and clients that lived in the city. In fact, that agency still does, and my two sons run it. I know that it works because we do cover a high percentage of those people through the FAIR plan and other programs.

So I am not walking away from your concerns. I just want to focus today on the issue at hand, which is reinsurance.

Ms. WHITEHEAD. It is part of an overall template of multifaceted ideas and efforts that need to be worked in concert lest we concentrate too much energy on one, and it is doomed to fail. There are things that we need to do in the community that only we can do, but we need to be in communication with regulators and insurers that respect our humanity and our intelligence and don't want to actuarially segment us into nonhuman entities as a way to overcome the problem.

Mr. KNOLLENBERG. Come to Michigan. I think we have a good program, and it works pretty well. You might want to borrow it and take it back and apply it to California.

Ms. WHITEHEAD. Come to Oakland. You will meet some nice folks.

Ms. WATERS. Thank you very much, Congressman, and all of our panelists. Whether it is Detroit, Michigan; Los Angeles or Oakland, California; St. Louis, Missouri; Chicago, Illinois; Philadelphia, what we see is deteriorated communities. Some used to be viable commercial centers. They continue to deteriorate. They need to be revitalized, and no one can deny that.

We believe that the issue of reinsurance is directly connected to the unavailability of primary insurance because the insurance companies that would offer insurance cannot afford to pay the prohibitive cost of reinsurance. So we think it is connected. We do not separate it, and this discussion today about primary insurance and reinsurance all makes good sense.

In the final analysis, some of us—and I will be in the leadership of it—must find a way to correct the problem, and we will not allow this Congress through public policy to say that they are the deserv-

ing constituencies at risk because somehow if you are the victim of disasters you deserve to have government involved in reinsurance in some ways.

But if you are the victims of communities that cannot get insurance for whatever reasons—because the insurance companies have moved out, because they think the risks are too high, because there is not enough experience data to help people to understand what they can do, because reinsurance is too high—we don't care what the reasons are. We are focusing on how we can get that insurance.

And we will look at it in every way that we possibly can, and we will not sit idly by and allow public policy to say there are those who are deserving in some way of government support, there are those who are not.

We may not be as concerned as you are, Mr. Nutter, about competition, but we won't allow the threat of competition to your reinsurance markets to stop us or deter us from getting government to help. We don't think it creates competition, but if it does reduce your price and you won't have it——

Thank you very much for being with us today. We really appreciate it.

If you have some information that you would like to share with us and continue to work to solve this problem we would welcome you, even if we differ somewhat about how to do it. If you have some new ideas about how to do it, we would welcome that, too. Thank you very much.

I would like to read a closing statement for the record, the formalized closing.

There being no further questions on behalf of the subcommittee, I want to express my appreciation to all the witnesses who shared their views with us today.

I ask unanimous consent that the record be kept open for a period of 4 weeks from today so that additional views may be submitted.

Hearing no objection, it is so ordered, the panel is excused, and the subcommittee is in recess. Now, I have formally closed this hearing. Thank you very much.

[Whereupon, at 11:42 a.m., the hearing was adjourned.]

APPENDIX

May 19, 1994

STATEMENT OF MAXINE WATERS
Hearing on H.R. 3298
The National Property Reinsurance Act

May 19, 1994

Mr. Chairman, members of the subcommittee, I am extremely grateful to have this opportunity to testify on behalf the subject of today's hearing -- H.R. 3298, the National Property Reinsurance Act -- which I introduced last October.

This subcommittee has charted a new course in policymaking. Under your leadership, Mr. Chairman, this Consumer Credit and Insurance Subcommittee has taken a hard look at many problems of low-income America that have traditionally scared legislators. Insurance redlining is one of those tough issues -- and that is the subject we will address today.

Insurance is a primary building block for economic development in this country. Without affordable insurance, private sector development is impossible. In my district of Los Angeles, which includes parts of South-Central L.A., businesses -- especially small businesses -- face enormous obstacles in obtaining insurance. We know that many insurance companies draw a red line around certain low-income and minority neighborhoods, and simply refuse to do business there. This practice economically cripples communities.

For example, the California Insurance Commissioner recently charged a San Francisco company with 252 violations of the State's insurance code after he was

presented with sworn affidavits by several company employees who presented company maps with lines around certain low-income and minority neighborhoods. The company subsequently agreed to pay a $400,000 fine and undergo reforms designed to increase its market share in underserved areas. The California Insurance Commissioner has proven legally what many low-income community dwellers have known by experience for years.

I have written legislation designed to induce insurance companies to do business in underserved areas. Let me underscore this point. H.R. 3298 is an <u>incentive-based, business-oriented</u> approach to the problem of insurance redlining. I think this legislation should appeal to <u>all</u> Members of this subcommittee. The bill we are discussing today <u>does not force</u> companies to insure in areas they may find risky. It attempts to reduce that perceived risk by allowing companies to sell a portion that risk to the government.

I believe my legislation very much complements the efforts of this and other in the area of insurance redlining. H.R. 3298 is a <u>programmatic</u> response to the crisis we see in so many communities. My bill is not meant to compete with the other Congressional initiatives. It would supplement them.

My legislation embodies a concept which I think has great potential to make a real difference in our most economically depressed areas. It is based on previously existing, or drastically reduced federal efforts to make crime and property insurance available in low-income areas. The premium-based fund which pays out excess claims is the same structure as the Riot Reinsurance program. Thus the FIA has

experience with what I am proposing.

These are the central elements of my bill:

1) The Federal Insurance Administrator, in consultation with state insurance authorities and community groups, would designate areas in each state in which property insurance coverage is not available or affordable for residences or businesses.

2) The Federal Insurance Administrator would then determine, by regulation, the terms, rates and appropriate coverage for reinsurance agreements available to pools and companies which operate in the designated areas.

3) The FIA would also determine, by regulation, an amount of coverage, above which the insurer or pool, would resume responsibility for coverage. Therefore, <u>the federal government would not face unlimited exposure to losses</u>.

4) Companies and insurance pools serving such areas would be eligible to enter into agreement with the Federal Insurance Administrator to share a portion of their risk.

5) The FIA would maintain a revolving fund comprised of the reinsurance premiums. The fund would be the source of payment for the coverage which might be required in accordance with the reinsurance agreements.

6) Insurance companies would then establish primary insurance rates within the designated areas -- which reflect the risk reduction from the reinsurance

coverage -- to be cleared by state insurance agencies.

This program leaves discretion to the Federal Insurance Administrator to implement through regulation many of the details that would be necessary to run a smooth and efficient program. We believe this flexibility would expedite the process and leaves the proper level of control with those who will operate the program.

At the end of this relatively simple process, insurance would be available at affordable rates, making it financially attractive to private companies to insure and allowing businesses to obtain insurance that had been previously unavailable.

I believe there are two primary reasons insurance coverage is as scarce as it is in many low-income communities today. First, there is a rational need to insure certain kinds of property at higher rates due to physical deterioration, concerns over health and safety codes, and differences in the risk of property damage in specific areas.

However, there is another, less rational basis for prohibitively high insurance rates -- and that is fear. There is a fear of the inner city, a fear of working in low-income areas, and a fear of the unknown. In many cases, this fear is not based on a rational understanding of the business climate that exists within communities.

To illustrate what I mean, the Missouri Insurance Commissioner recently found that insurers there charged policyholders in low-income minority areas higher premiums than they did policymakers in low-

income white areas for comparable policies even though the losses were higher in the white communities. Residents in the minority areas were paying premiums one and one half times those in the white areas -- for inferior policies, while the loss ratios were 72% in the white areas, compared to 57% in the minority areas.

One of the intangible benefits of legislation like H.R. 3298 would be that once companies are financially induced into areas they have avoided, they will learn what many people already know -- it is possible to establish, develop and grow in many low-income and minority areas. In the long run, we will reduce the fear factor among many companies and the perceived risk of doing business will reflect a more rational understanding of actual risk.

LUIS V. GUTIERREZ
4TH DISTRICT, ILLINOIS
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEES:
HOUSING AND COMMUNITY DEVELOPMENT
CONSUMER CREDIT AND INSURANCE
COMMITTEE ON VETERANS' AFFAIRS
SUBCOMMITTEES
HOSPITALS AND HEALTH CARE
OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON FOREIGN AFFAIRS
SUBCOMMITTEE
ASIA AND THE PACIFIC

Congress of the United States
House of Representatives
Washington, DC 20515-1304

1208 LONGWORTH BUILDING
WASHINGTON, DC 20515
(202) 225-8203
3181 NORTH ELSTON AVE.
CHICAGO, IL 60618
(312) 509-0999
1751 WEST 47TH STREET, 2ND FLOOR
CHICAGO, ILLINOIS 60609
(312) 247-9020

OPENING STATEMENT
CONGRESSMAN LUIS V. GUTIERREZ
SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE
MAY 19, 1994

MR. CHAIRMAN, I WANT TO THANK YOU FOR HAVING THIS HEARING TODAY AND CONGRATULATE CONGRESSWOMAN WATERS ON HER LEGISLATION. JUST YESTERDAY, I MENTIONED THIS HEARING TO AN OFFICIAL FROM CHICAGO. THIS INDIVIDUAL'S REACTION WAS VERY POSITIVE. SHE STATED THAT THIS IS EXACTLY THE TYPE OF ASSISTANCE THE CITY OF CHICAGO NEEDS.

THERE ARE SO MANY AREAS OF MY CITY THAT HAVE BEEN ABANDONED BY BUSINESS, AND NOT ALWAYS UNJUSTIFIABLY. WE SEE IT ALL THE TIME -- WHEN THE MORE MODERATE INCOME INDIVIDUALS MOVE OUT OF A NEIGHBORHOOD, THE NEXT THING TO GO ARE THE SHOPS AND SMALL BUSINESSES. BUSINESSES THAT ARE CRITICAL TO THE VIABILITY AND GROWTH OF AN AREA. WHAT WE HAVE LEFT ARE VACANT BUILDINGS WITH GRAFFITI AND BROKEN WINDOWS, WHICH ONLY FURTHER CONTRIBUTES TO THE DECLINE OF THE NEIGHBORHOOD.

I BELIEVE THIS BILL COULD HELP REJUVENATE THESE AREAS, DRAWING BUSINESS BACK IN AND IN TURN, HELPING OUR NEIGHBORHOODS BY PROVIDING JOBS, PROVIDING SERVICES, AND MOST IMPORTANTLY, BY

PROVIDING THE BUILDING BLOCKS NECESSARY FOR A SOUND COMMUNITY.

I LOOK FORWARD TO HEARING MORE ABOUT THIS PROGRAM. THANK YOU, MR. CHAIRMAN.

BERNARD SANDERS
MEMBER OF CONGRESS
VERMONT, AT LARGE

213 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-4501
TELEPHONE: 202-225-4115
FAX: 202-225-6790

Congress of the United States
House of Representatives
Washington, DC 20515-4501

COMMITTEES:
BANKING, FINANCE AND URBAN AFFAIRS
GOVERNMENT OPERATIONS

1 CHURCH STREET, SECOND FLOOR
BURLINGTON, VT 05401-4417
TELEPHONE: 802-862-0697
TOLL FREE: 800-339-9834
FAX: 802-860-6370

Statement of Rep. Bernard Sanders
Subcommittee on Consumer Credit and Insurance
May 19, 1994

Thank you, Chairman Kennedy, for holding this important hearing. Your interest in abolishing redlining in the insurance industry has produced laudatory results. If adopted, your legislation would provide a solid foundation upon which to build protections against redlining.

Ms. Waters' bill, the National Property Reinsurance Act, complements your commendable efforts by diluting the bitter risk that impoverished areas pose to insurers. It promotes the availability and affordability of property insurance in currently redlined areas through a reinsurance program offered by the Federal Insurance Administrator.

The wealthy and upper-middle classes can deposit their earnings in bank accounts insured by the Federal Deposit Insurance Corporation. Unlike the wealthy, the lower and lower-middle classes cannot safeguard their earnings in this way because their earnings, and often their livelihood, are tied up in the equity of their homes and other property. We should offer them the same protections we offer the wealthy. Ms. Waters' bill provides these safeguards by offering insurance companies a risk-sharing pool similar to that offered to banks by the FDIC.

STATEMENT OF ELAINE A. MCREYNOLDS

FEDERAL EMERGENCY MANAGEMENT AGENCY

BEFORE THE

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

OF THE

HOUSE OF REPRESENTATIVES

MAY 19, 1994

GOOD MORNING! I AM VERY PLEASED TO APPEAR AT THIS HEARING TODAY ON THE NATIONAL PROPERTY REINSURANCE ACT.

THE COMMITTEE AND THE BILL'S SPONSOR, CONGRESSWOMAN WATERS, ARE TO BE COMMENDED FOR THEIR CONSIDERATION OF THE EXTENT TO WHICH PROPERTY INSURANCE IS AVAILABLE AND AFFORDABLE IN THE PRIVATE INSURANCE MARKET, PARTICULARLY IN THE CITIES AND RURAL AREAS OF THE NATION.

YOUR INQUIRY INTO PROPERTY INSURANCE AVAILABILITY IS VERY TIMELY. WE KNOW THAT IN RESPONSE TO HOMEOWNERS INSURANCE UNAVAILABILITY IN FLORIDA AND HAWAII, STATE INSURANCE MECHANISM'S WERE LEGISLATED TO FILL THE VOID. FLORIDA'S JOINT UNDERWRITING ASSOCIATION HAS ALREADY GROWN TO THE POINT WHERE THERE ARE NOW ABOUT 455,000 HOMEOWNERS INSURED UNDER THE PROGRAM.

THE FACT THAT THE NEED WAS THERE IS EVIDENT. WHETHER IT IS A RELATIVELY TEMPORARY NEED THAT IS BEING MET OR WHETHER IT PORTENDS A LONG-TERM FUTURE IN STATE INSURANCE

MECHANISMS AS A CURE FOR PRIVATE INSURANCE MARKET UNAVAILABILITY, REMAINS TO BE SEEN. BUT, THE SITUATION CERTAINLY SENDS A STRONG SIGNAL TO PUBLIC OFFICIALS AND LEGISLATORS, AS WELL, THAT A WATCHFUL EYE MUST BE CAST UPON THE CURRENT STATE OF INSURANCE AVAILABILITY AND AFFORDABILITY. YOU ARE DOING JUST THAT IN THIS HEARING. I'M PROUD TO BE CALLED UPON BY YOU.

I MUST TELL YOU AT THE OUTSET, THAT WE ARE IN THE PROCESS OF REVIEWING THE SPECIFIC PROPOSALS FOR REINSURANCE IN H.R. 3298 AND WOULD LIKE AN OPPORTUNITY TO SUPPLY WRITTEN VIEWS ON THE BILL.

THE ISSUE OF REINSURANCE IS VERY COMPLEX AND DIFFICULT, ESPECIALLY THE PRICING WITH VARIOUS INDIVIDUAL INSURERS, AS COMPARED TO THE MORE BASIC, DIRECT PROGRAMS OF INSURANCE. WE WILL NEED MORE TIME TO PROPERLY ASSESS ALL OF THE RAMIFICATIONS OF THE BILL.

I BELIEVE THAT THERE MAY WELL BE INSURANCE MARKET DISLOCATIONS IN SOME AREAS BEING EXPERIENCED BY RESIDENTIAL AND BUSINESS PROPERTY OWNERS.

THUS, IT MAY BE THAT THE PRIVATE INSURANCE MARKETS, ENDEMICALLY, ARE SOMEWHAT DYSFUNCTIONAL IN CERTAIN AREAS OF THE COUNTRY. I WOULD LIKE TO WORK WITH YOU AND OFFER WHATEVER ASSISTANCE I CAN IN DEALING WITH THE INSURANCE PROBLEMS WHICH MAY BE ENCOUNTERED IN INDIVIDUAL COMMUNITIES.

I DO HAVE WHAT IS BELIEVED TO BE A PROPERTY INSURANCE MARKETING PROBLEM TO PRESENT FOR THE COMMITTEE'S ATTENTION. ONE THAT I BECAME VERY FAMILIAR WITH WHEN I SERVED THE STATE OF TENNESSEE AS ITS COMMISSIONER OF INSURANCE AND COMMERCE, AND ONE THAT I HAVE LOOKED INTO PERSONALLY IN MY SHORT TENURE AS FEMA'S FEDERAL INSURANCE ADMINISTRATOR.

I REFER TO THE AVAILABILITY OF THE FEDERAL CRIME INSURANCE PROGRAM.

THE FEDERAL CRIME INSURANCE PROGRAM (FCIP) WAS ESTABLISHED BY CONGRESS IN 1970. IT IS ADMINISTERED BY THE FEDERAL EMERGENCY MANAGEMENT AGENCY THROUGH ITS FEDERAL INSURANCE ADMINISTRATION, WHICH IS AUTHORIZED TO OFFER FEDERAL CRIME INSURANCE POLICIES IN STATES IN WHICH IT IS CONCLUDED THAT THERE EXISTS A CRITICAL PROBLEM IN THE AVAILABILITY OF CRIME INSURANCE. IN 1991, 14 STATES, THE DISTRICT OF COLUMBIA, PUERTO RICO, AND THE VIRGIN ISLANDS WERE PARTICIPATING IN THE PROGRAM. POLICIES, OFFERED BOTH TO INDIVIDUALS AND BUSINESSES, COVER LOSSES DUE TO ROBBERY AND BURGLARY.

IN 1992, THE NUMBER OF PARTICIPATING JURISDICTIONS WAS REDUCED TO 8 STATES AND THE DISTRICT OF COLUMBIA, PUERTO RICO AND THE VIRGIN ISLANDS. THREE STATES, DELAWARE, RHODE ISLAND AND TENNESSEE, WERE REMOVED FROM THE FCIP EFFECTIVE JULY 1, 1992, AND THREE OTHERS, ALABAMA, CONNECTICUT AND GEORGIA WERE REMOVED EFFECTIVE DECEMBER 1, 1992.

SUBSEQUENTLY, AFTER I PERSONALLY INTERVENED AS TENNESSEE'S COMMISSIONER OF INSURANCE, ON JUNE 30, 1993, THE STATE OF TENNESSEE WAS RE-ADMITTED INTO THE FCIP.

AS OF NOW, THERE ARE TWELVE JURISDICTIONS IN THE FCIP: CALIFORNIA, FLORIDA, ILLINOIS, KANSAS, MARYLAND, NEW JERSEY, NEW YORK, PENNSYLVANIA, TENNESSEE, DISTRICT OF COLUMBIA, PUERTO RICO, AND THE VIRGIN ISLANDS.

THERE ARE 16,625 POLICIES-IN-FORCE, OF WHICH 13,855 INSURE RESIDENCES, AND 2,770 INSURE BUSINESSES AGAINST THE CRIMES OF ROBBERY AND BURGLARY. THE TOTAL INSURANCE COVERAGE IN FORCE IS OVER $151 MILLION.

IN 1980, THERE WERE TWENTY-SIX STATES AND OTHER JURISDICTIONS IN THE FCIP, IN WHICH 62,544 RESIDENTIAL PROPERTY OWNERS AND 20,619 COMMERCIAL PROPERTY OWNERS WERE INSURED. THUS, THROUGH THE DECADE OF THE 80S AND DURING THE LAST FEW YEARS, THE FCIP HAS SHRUNK TO ITS

CURRENT STATE THROUGH, I BELIEVE, LACK OF A VIGOROUS MARKETING PROGRAM AND SOME SERIOUS FLAWS IN ITS OPERATIONS.

WE HAVE TAKEN A HARD LOOK AT THE MARKETING EFFORTS ON BEHALF OF THE FCIP THE PAST DOZEN YEARS OR SO AND FOUND THEY WERE VIRTUALLY NON-EXISTENT. INDEED, PREVIOUSLY, A PREFERENCE HAD BEEN EXPRESSED FOR THE TERMINATION OF THE FEDERAL CRIME INSURANCE PROGRAM, AFTER IT HAD BECOME DOWNSIZED AND ALMOST MORIBUND, ON THE GROUNDS THAT ONLY A FEW STATES WERE ELIGIBLE FOR THE PROGRAM.

LOOKING AT THE OPERATION OF THE PROGRAM, IT IS APPARENT THAT THE FCIP WAS MADE AVAILABLE IN STATES WHICH ACKNOWLEDGED THAT THEY HAD A CRITICAL CRIME INSURANCE AVAILABILITY PROBLEM. CRIME INSURANCE WAS NOT MADE AVAILABLE ON A CITY-BY-CITY BASIS, OR IN OTHER AREAS IN THE STATE UNDERSERVED BY THE MARKET FORCES, UNLESS THE STATE ITSELF, CAME INTO THE PROGRAM. SOME OTHER CONCERNS WITH

THE PROGRAM NEEDED TO BE LOOKED AT, SUCH AS ACCESSIBILITY OF INSURANCE, THE ADMINISTRATIVE PROCESS UNDER WHICH STATES BECOME ELIGIBLE, AND THE PROGRAM'S INSURANCE POLICY CONDITIONS, AS COMPARED TO WHAT IS AVAILABLE IN THE PRIVATE SECTOR.

CRIME INSURANCE UNAVAILABILITY IS STILL A PROBLEM IN MANY STATES. MY OWN STATE OF TENNESSEE IS AN EXAMPLE. SO IS THE STATE OF WASHINGTON, WHICH ASKED FOR RE-ENTRY INTO THE PROGRAM IN 1991. THE TERRITORY OF PUERTO RICO HAS RECENTLY ASKED FOR AN INCREASED MARKETING EFFORT THERE.

ALSO, LAST DECEMBER, CONGRESSMEN JOHN LAFALCE AND CHARLES SCHUMER OF NEW YORK HELD HEARINGS IN BUFFALO, NEW YORK, ON THE PLIGHT OF THE SMALL BUSINESS OWNERS IN THE NATION WHO ARE FACED WITH HIGH CRIME RATES AND UNAVAILABILITY OF CRIME INSURANCE. THEY CITED A REPORT ON THE SUBJECT CONCERNING A COMMUNITY OF SMALL BUSINESSES IN COLUMBUS, OHIO, AND I HOPE TO OBTAIN AND REVIEW THAT

REPORT. INTERESTINGLY, OHIO, IS ONE OF THE EIGHT STATES THAT LEFT THE FCIP IN THE MID-EIGHTIES TO SET UP ITS OWN CRIME INSURANCE PROGRAM.

I PLAN TO BE PRO-ACTIVE AND LOOK IN ON THESE STATES TO SEE IF THERE IS ANY INTEREST IN RE-JOINING THE FCIP.

A SERIOUS AND SUSTAINED MARKETING EFFORT FOR FEDERAL CRIME INSURANCE CAN HELP RESIDENTIAL AND SMALL BUSINESS PROPERTY OWNERS OBTAIN THE AFFORDABLE INSURANCE THEY DESERVE.

WE ARE LOOKING AT OUR POLICY FORMS, RATES, UNDERWRITING RULES, AND AVAILABLE COVERAGE TO PRESENT THE MOST ATTRACTIVE, YET COST-EFFECTIVE PROGRAM, THAT WE CAN TO OUR CONSUMERS. IF IT TURNS OUT THAT WE OVERESTIMATED THE MARKET TO SOME EXTENT THAT, TOO WILL PROVIDE VALUABLE INSIGHTS.

RETURNING TO H.R.3298, THE PARADIGM EFFORT WE ARE UNDERTAKING IN THE FCIP...STATE-BY-STATE, MARKET-BY-MARKET... MAY BE AN APPROACH MERITING CONSIDERATION FOR OTHER SERIOUS INSURANCE MARKET UNAVAILABILITY PROBLEMS ON AN INDIVIDUAL LINE OF INSURANCE BASIS, RATHER THAN ON AN ALL STANDARD LINES, COUNTRYWIDE BASIS.

I HOPE THESE THOUGHTS WILL BE OF ASSISTANCE IN THE FINE WORK YOU ARE ENGAGED IN. ONCE WE HAVE A CHANCE TO THOROUGHLY REVIEW THE BILL WITH THE ADMINISTRATION, WE WILL BE PLEASED TO PROVIDE YOU WITH ADDITIONAL THOUGHTS AND OBSERVATIONS. I WOULD BE PLEASED TO ANSWER ANY QUESTIONS YOU MAY HAVE.

RAA
REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

STATEMENT

of

FRANKLIN W. NUTTER
President

on behalf of the

REINSURANCE ASSOCIATION OF AMERICA

Before the

U.S. HOUSE OF REPRESENTATIVES

BANKING, FINANCE AND URBAN AFFAIRS

SUBCOMMITTEE ON CONSUMER CREDIT
& INSURANCE

May 19, 1994

1301 Pennsylvania Ave., N.W.
Suite 900
Washington, D.C. 20004
202/638-3690

REINSURANCE ASSOCIATION OF AMERICA

1301 Pennsylvania Ave., N.W., Washington, D.C. 20004 • (202) 638-3690 • Facsimile: (202) 638-0936

MEMBER COMPANIES
1993

American Re-Insurance Company
American Royal Reinsurance Company
AXA Reinsurance Company
Chartwell Reinsurance Company
Christiania General Insurance Corporation of New York
CIGNA Reinsurance Company
Constitution Reinsurance Corporation
Employers Reinsurance Corporation
General Reinsurance Corporation
General Security Assurance Corporation
Gerling Global Reinsurance Corporation
The Mercantile & General Reinsurance Company of America
Munich American Reinsurance Company
NAC Reinsurance Corporation
National Reinsurance Corporation
North American Reinsurance Corporation
North Star Reinsurance Corporation
PMA Reinsurance Corporation
Prudential Reinsurance Company
The Reinsurance Corporation of New York
San Francisco Reinsurance Company
Scor Reinsurance Company
Skandia America Reinsurance Corporation
Trenwick America Reinsurance Corporation
Underwriters Reinsurance Company
Winterthur Reinsurance Corporation

The Reinsurance Association of America (RAA) is a non-profit trade association of 26 professional property and casualty reinsurers; the principal business of these companies is the assumption of property and casualty reinsurance from other insurers All members of the RAA are either domestic United States companies or U.S. branches of foreign reinsurers.

The principle purpose of the RAA is to promote the interests of the property-casualty reinsurance industry before the Congress of the United States, state legislatures, federal and state regulatory entities and the public.

Statement of
Franklin W. Nutter
President, Reinsurance Association
of America

before the
House of Representatives
Banking, Finance and Urban Affairs
Subcommittee on Consumer Credit
and Insurance

May 19, 1994

Chairman Kennedy, members of the Subcommittee, I am Franklin W. Nutter, president of the Reinsurance Association of America (RAA), and it is my pleasure to be here today to discuss HR 3298, the National Property Reinsurance Act.

The RAA is a trade association of domestic professional property-casualty reinsurance companies whose 29 members write approximately 75 percent of all reinsurance written by that segment of the market. We commend you and your colleagues for examining the issue of insurance availability in underserved areas. It is the position of the RAA that resurrecting a government property reinsurance program as called for in HR 3298 when no market need for it exists would be inappropriate, and we urge you to seek more constructive means of addressing the issue of insurance availability.

Reinsurance has been described as the "insurance of insurance companies." After evaluating the risks they assume, insurers purchase reinsurance coverage as a means of spreading those risks throughout the national and international reinsurance markets. Today, the U.S. reinsurance market, with annual premiums of approximately $25 billion, consists of professional reinsurers, departments of primary insurers and foreign reinsurers.

Reinsurance allows companies to minimize the wide fluctuations inherent in the underwriting cycle. It allows companies to protect themselves from catastrophic exposures. And it allows companies to safely write business their capital base would not otherwise allow.

However, it is also important to recognize what reinsurance can not do. It can not compensate for underlying rates that are not actuarially sound. And it can not correct underwriting strategies that leave a primary company unable to meet its financial obligations. In short, reinsurance is a tool that enables the risk-spreading mechanism to operate more efficiently, not a substitute for risk diversification and sound financial management.

The bill being considered today, HR 3298, would reauthorize and expand the Federal Riot Reinsurance Program to provide standard property reinsurance coverage for risks located in areas deemed to be underserved. The RAA opposes this particular measure for three fundamental reasons.

The first is that it presupposes a market failure or deficiency which simply does not exist. Reinsurance for riot or other urban risks is widely available in the private market. The National Association of Insurance Commissioners (NAIC) found that to be the case in testimony before the Senate in 1980, and the Congress itself found that to be the case when it repealed the Riot Reinsurance Program in 1983. That fact has not changed in the ensuing 11 years. Indeed, reinsurance capacity has increased dramatically since that time.

In fact, the NAIC conducted a survey of urban insurance issues in late 1992 asking each state regulator -- in extremely broad language -- whether he or she had "any indications" that reinsurers were reacting to the Los Angeles riots in their pricing or coverage practices, or had received complaints about cancellations or non-renewals on reinsurance coverage. Forty of 41 commissioners responded "no" to both questions, which I believe is a remarkable testimony to the existence of a vital and competitive private reinsurance market.

Before entering the reinsurance business, Congress should look long and hard at whether the private sector has failed to provide adequate coverage. In the case of property reinsurance for urban risks, Congress will find that this coverage is readily available at affordable prices. Individual company circumstances may necessitate variances in rates reflecting a reinsured company's loss experience and the nature of its underlying policyholder base. However, the U.S. private reinsurance market is highly price-competitive.

Proponents of the bill may argue that there is indeed an insurance market failure, citing the existence of the Fair Access to Insurance Requirements, or FAIR plans, as proof that the private insurance market alone is not providing adequate coverage to inner-city areas. The FAIR plans were designed to be a part of the solution of urban insurance availability, and evidence suggests that they have successfully service in that capacity. However, their existence has no bearing on whether private reinsurance coverage is available, and reinsurance coverage of FAIR plan exposure is routinely included in reinsurance contracts.

The second fundamental reason for opposing HR 3298 is that it adopts an approach that Congress has already rejected. In 1968, after the Hughes Commission issued its watershed report on the link between inner-city vitality and insurance availability, Congress created the Federal Riot Reinsurance Program to encourage property insurance coverage for urban risks. The need for the program was immediately challenged as the private reinsurance market met the reinsurance needs of the primary industry. Within 15 years Congress repealed the program, which, by then, had only one company participating -- hardly a resounding success.

Besides the market reactions that made the program superfluous, the structure and management of the program also left much to be desired. States objected to the heavy financial burden it placed on them. Insurers criticized its rating system and lack of service. And the only beneficiary of the program, beyond the handful of companies submitting claims, was the Federal Crime Insurance Program which raided the reinsurance premiums collected to meet its own monetary shortfall.

Each of these concerns would apply in equal force to the program proposed by HR 3298.

The third fundamental reason for our opposition to the proposal is that it will not work. The bill's goal is primarily to encourage insurers to write property coverage in the nation's inner-cities. However, there exists no significant relationship between insurers' ability to provide urban property insurance coverage and the availability of reinsurance.

That reality, originally expressed by insurance commissioners in opposition to the old Riot Reinsurance Program in 1980, is no less true today.

Reinsurance only reflects the underlying risks assumed by the insurer. Unless the government can reduce losses associated with urban risks or subsidize its own reinsurance rates, a federal mechanism that competes with an active private marketplace will have little or no effect on the ability of insurers to provide additional inner-city coverage or reduce insurance prices to policyholders; particularly since HR 3298 requires actuarially sound rates.

In conclusion, I urge the Subcommittee to defer the creation of such a major program as envisioned by HR 3298 until those parties examining the issue of urban insurance availability have completed their analysis. State regulators are conducting a comprehensive data-call intended to assess the urban availability issue; and Congress appears poised to adopt its own form of disclosure requirements which should also shed much-needed light on the issue.

HR 3298 is not the appropriate government response to this issue. It is unnecessary. It is based on a model that experience shows does not work. And it would do little to address the concerns expressed by the Subcommittee.

I thank the Subcommittee for this opportunity to comment.

Before the House of Representatives of the United States of America

Hearing On:

H.R. 3298, The National Property Reinsurance Act

May 19, 1994

Subcommittee on Consumer Credit and Insurance
of the
Committee on Banking, Finance and Urban Affairs

Joseph P. Kennedy II,
Chairman

Written Statement
of
Selwyn Whitehead
President
The Economic Empowerment Foundation
Corporate Social Responsibility Institute
4650 Scotia Avenue
Oakland, CA 94605

(510) 238-6875

Contents

Part One: Introduction

Good morning. My name is Selwyn Whitehead. I am the president and executive director of the Economic Empowerment Foundation headquartered in Oakland, California. The Foundation is a non-profit corporation that is determined to help bring the small business development and expansion and home-ownership financial and technical assistance resources back into historically underserved communities. These resources are necessary for those of us who live in these communities to create the economic wealth and stability that is necessary to spur on the economic growth of persons and community of color, low-to-moderate income individuals, women, and community based small and micro-businesses. The Foundation also strives to shin a light on those political and regulatory bodies that have abdicated their responsibility to compel banks, insurance companies and other financial institutions to perform their capital formation and and financial product access functions in a nondiscriminatory manner.

Our direction comes from a Community Advisory Board which is made up of real every day real people from throughout the communities we serve. These people and the other individuals we rely on throughout Oakland, California and the Nation to advise the Foundation, are not only knowledgeable about the needs of their communities, but are willing and able as well to assist the Foundation in performing the thoughtful research and analysis that is necessary to bring about the needed change.

Because our primary focus is that of community economic development via access to the the financial services industry, we also utilized the services of what I call my "Good old Board" of knowledgeable mostly white male financial industry insiders who for what ever reasons are willing

to tell us honestly what the down side implications of any of our proposal might be on the economy in general, and what negative consequences they might have on a particular industry or institution.

Armed with this knowledge, the Foundation employes community-based advocacy, education and policy development to encourage corporate America in general and the financial sector in particular to abandon its institutionalized practice of economic apartheid.

I want to take this opportunity thank Ms. Waters for drafting H.R. 3298 and Mr. Kennedy for holding this hearing and affording me this opportunity discuss the merits of the bill and explain why I believe it is a necessary component in an overall strategy to make property insurance more accessible, affordable and available in historically underserved communities like South Central Los Angeles and East Oakland.

I must inform you that low to moderate income and of-color residents and business owners in our urban centers like South Central Los Angeles and East Oakland desperately need the United States Congress to establish oversight, regulations and legislation which first establishes a mechanism for collecting information about the affordability, availability and accessibility of insurance products and investments along with the underwriting practices of the insurance industry in historically underserved communities. This oversight, regulation and legislation must be realized through the passage of either the Collins or Kennedy Insurance Industry Anti-Redlining Acts, which ever one can be passed before the end of the 103rd Congress.

Then this oversight, regulation and legislation should cause the implementation of a series of targeted incentives and penalties that move the insurance industry to fulfill its covenant with government to make its products, services and investments available to all good risks in exchanges for

the non-invasive oversight it has enjoyed for decades. The necessary oversight, regulation and legislation should compel the industry to seek out and serve the available pool of good risks we all know dwell in these economically isolated communities. The necessary oversight, regulation and legislation should contain a mechanisms to have the industry report to a governoring body on an annual basis the statics that show how it is serving these communities by product type, marketing method and investment vehicle. The incentive part of this necessary oversight, regulation and legislation should take the form of the Ms. Water's National Property Reinsurance Act. The penalty part can be discussed at another time and place.

Both components, the data collection and the market service incentive, of this necessary oversight, regulation and legislation must be put into effect right away because our communities can not wait and will no longer be denied access to the insurance industry resources we require. Fore we have come to a point in time where our children's very lives depend on us acquiring these resources and reclaiming our communities, their legacy, on their behalf before they destroy themselves while we wait for others to do the job God requires of us as their "parents".

Part Two: What is My Definition of Redlining?

My definition of redlining is erection of artificial race-, gender-, or class-based barriers that inhibit persons of color and women from reaching their full economic potential. In the case of insurance redlining it relates to the erection of artificial barriers to affordable and available insurance products and short and long term investment in communities of color.

Part Three: How Does Redlining Manifest Itself In Communities Like East Oakland

Insurance Product Redlining

First to give you a better feel of our community, I have provided below at table 1 the East Oakland Gross Community Income Profile and a census tract map which gives you a picture of the primary areas of focus of the Foundation's East Oakland Revitalization Area in the Flatland of East Oakland. The seven designated areas indicate community controlled business development and homeownership development projects or programs that the Foundation is working to provide access to financial industry resources for the local community groups to get off the ground. I would point out that Area 4 is the focal point of a successful revitalization effort lead by the leadership of the Church we are meeting in today.

The profile shows that East Oakland is an economically vital community, producing a gross community income of nearly $1.4 billion annually. The average household income is more than $32,000. Ours is certainly a community where insurers could find some good risks to sell their standard and premium products. This is especially the case in light of

Table 1: East Oakland Gross Community Income Profile

Central East Oakland Gross Community Income 1990:

Census Tract	Population	Mean Income	Median Income	PerCap Income	Neighborhood	Median Home Value	Community Income
4073	1,911	$25,759	$23,750	$8,784	Melrose	$89,800	$16,786,224
4074	3,640	$26,750	$23,505	$8,241	Fairfax	$91,700	$29,997,240
4075	3,812	$26,376	$19,713	$7,898	Seminary	$96,200	$30,107,176
4076	6,201	$33,251	$29,208	$11,038	Fremont	$125,800	$68,446,638
4077	4,792	$39,229	$35,877	$15,149	Maxwell Park	$156,100	$72,594,008
4078	2,495	$44,187	$42,331	$13,665	Maxwell Park/ Mills College	$164,500	$34,094,175
4082	4,153	$35,449	$31,680	$14,436	Millsmont	$145,500	$59,952,708
4086	4,653	$25,388	$20,529	$9,113	Hegenberger	$93,900	$42,402,789
4087	6,602	$30,270	$24,221	$10,352	Havenscourt	$96,800	$68,343,904
4088	4,752	$17,683	$12,736	$5,888	Lockwood/ Tevis	$78,800	$27,979,776
Sub	43,011					Subtotal	$450,704,638

Elmhurst District Gross Community Income 1990:

Census Tract	Population	Mean Income	Median Income	PerCap Income	Neighborhood	Median Home Value	Community Income
4083	4,517	$44,126	$37,310	$16,939	Eastmont Hills	$155,700	$76,513,463
4084	3,399	$24,336	$19,715	$8,882	Eastmont	$97,500	$30,189,918
4085	4,578	$29,020	$21,859	$9,784	Arroyo Viejo	$97,800	$44,791,152
4089	2,900	$22,057	$14,099	$7,523	Fitchburg	$83,900	$21,816,700
4090	3,023	$25,434	$18,030	$8,105	Columbia Gardens	$82,100	$24,501,415
4091	1,936	$29,380	$24,722	$9,193	Brookfield	$77,300	$17,797,648
4092	2,736	$29,068	$24,550	$8,354	Sobrante Park	$83,600	$22,856,544
4093	4,605	$27,045	$23,523	$8,361	Stonehurst	$94,200	$38,502,405
4094	3,667	$24,790	$19,089	$7,409	Elmhurst Park	$86,100	$27,168,803
4095	2,686	$25,215	$20,734	$7,479	Highland/ Woodland	$81,300	$20,088,594
4096	4,432	$27,142	$21,292	$8,913	Webster/Cox	$93,600	$39,502,416
4097	4,499	$24,300	$20,702	$8,352	Castlemont	$97,500	$37,575,648
4098	3,082	$42,006	$33,864	$15,258	Toler Heights/ Golf Links	$172,000	$47,025,156
4101	2,785	$48,968	$32,833	$13,265	Foothill Square	$132,300	$36,943,025
4102	3,132	$30,911	$27,350	$10,281	Los Palmas	$110,900	$32,200,092
4103	2,993	$26,357	$23,843	$8,583	Ivywood	$94,300	$25,688,919
4104	2,890	$30,911	$27,350	$10,281	Durant Manor	$121,300	$29,712,090
Sub	57,860					Subtotal	$572,873,988

Adjacent Oakland Hills Community Gross Community Income 1990

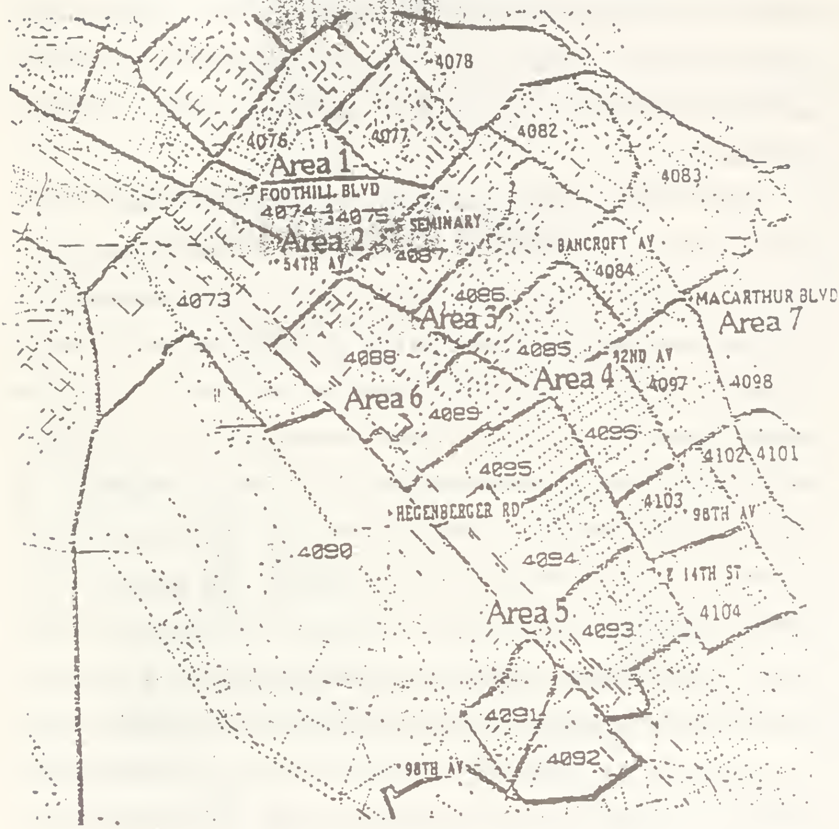
Census Tract	Population	Mean Income	Medium Income	PerCap Income	Neighborhood	Median Home Value	Community Income
4081	5,901	$81,080	$62,380	$31,398	Oakland Hills	$351,200	$185,279,598
4099	4,201	$62,822	$53,748	$23,819	Oakland Hills	$270,700	$100,063,619
4100	2,720	$60,594	$54,587	$29,055	Oakland Hills	$256,400	$79,029,600
Sub	12,822					Subtotal	$364,372,817
Total	113,693					Total	$1,387,951,443

Source: 1990 Census, the Oakland Chapter of the National Association of Real Estate Brokers, Inc. and the Associated Real Property Brokers, Inc.[1]

[1] Representing the 400 full- and part-time Black real estate brokers and agents in Alameda County.

The Economic Empowerment Foundation

East Oakland Revitalization Target Area Map



Target Area Census Tracts:

Revitalization Node	Census Tracts
1. Bancroft/Seminary/Foothill	4074, 4075, 4076, 4077, 4087
2. East 14th, 55th to Seminary:	4073, 4075
3. Hegenberger and East 14th:	4085, 4089, 4095, 4096
4. 85th and East 14th	4095, 4096
5. 98th and Edes:	4091, 4092, 4093, 4094
6. Coliseum BART Station Area:	4088, 4089,4090
7. Eastmont Mall/Macarthur/Foothill Square:	4082, 4083, 4084, 4086 4097, 4098, 4101, 4102

the fact that we residents of the area are doing all that we can to make our community a better place to live and work for our children. But that would require the insurance industry to get past its chicken hearted race-, gender- and class-based underwriting guidelines, something it as heretofore been unable to do.

The most ironic thing about insurance redlining is that I have for the past eight years been fighting with banks to end their redlining ways and develop programs for first time home buyer and home rehabilitators in historically underserved communities. And fighting with Fannie Mae to change its biased underwriting guidelines so the banks can make the necessary loans. Now that the banks and Fannie Mae are working with us in East Oakland because they see an opportunity to make a profit, it appears that our efforts will be hampered by insurers who are too stupid to realize that they too can make a reasonable profit selling standard products to us. Inasmuch as neither a bank or Fannie Mae will allow a loan to be made without proper insurance, many of us are forced to continue to buy from fly by night insurance companies or the Fair Plan and hope we never have a loss or a loss that is not covered by the Fair Plan. **THIS IS INSURANCE PRODUCT REDLINING**, and is bad public policy and must not be allowed to continue.

The State Farm Example

Below at Table 2 are the results of the Foundation's examination of State Farm's market penetration in selected communities in Oakland. For the record State Farm is the largest insurer not only here in California but also nationally. Also for the record, the Foundation is currently intervening

in State Farm's rate hearing before the Department of Insurance. The results of the examination I am about to share have already been provided as evidence by me in that hearing. Our simple examination took the form of a comparison of two zip codes served by State Farm in Oakland for the year 1991. One zip code 94611 has a predominantly white population base, while the other zip code 94605, where I live, is predominantly black. We see that the predominantly white zip code although having 27.3% fewer families to serve had two State Farm sales agents while the predominantly black zip code had not a single agency. The predominantly white zip code with only 6,700 families had 10,134 units of homeowner insurance in effect in 1991 for a coverage ratio of 1.51 to 1, while the predominantly black zip code with 9,228 families had only 8,141 units of homeowners insurance in effect in 1991 for a coverage ratio of .88 to 1. Also telling is the fact that State Farm provides homeowners coverage to 30.4 % of the families in the white zip code and only 22.6% of the families in the black zip code. There appears to be disparate treatment of these populations by State Farm which could result in supracompetitive premiums being charged to consumers with limited access to other carriers.

Table 2. A Comparison of State Farm's Market Coverage of Zip Codes 94611 and 94605 for 1991

Zip Code 94611

All Companies Policy Count: 10,134 State Farm Policy Count: 2,041 State Farm Agent Count: 2

Census Track	Population	Families	Med Income	% Black
4035	6,171	1,062	$24,779	42.8
4040	2,844	485	$35,550	17.9
4041	5,553	866	$37,339	7.4
4044	4,420	1,148	$57,500	4.9
4045.01	1,547	467	$64,752	3.7
4045.02	5,285	1,470	$64,756	5.2
4046	4,112	1,202	$76,820	4.5
Total	29,932	6,700		

Units of Insurance Coverage Per Family	State Farm Percentage Of Available Coverage	Families Per State Farm Agent
1.51:1	30.4%	3350

Zip Code 94605

All Companies Policy Count: 8,141 State Farm Policy Count: 2,089 State Farm Agent Count: 0

Census Track	Population	Families	Med Income	% Black
4082	4,153	1,051	$36,406	69.9
4083	4,517	1,166	$33,325	59.0
4084	3,399	829	$27,354	83.3
4087	6,602	1,638	$32,065	68.7
4097	4,499	1,072	$20,193	81.4
4098	3,082	826	$38,317	81.7
4099	4,201	1,105	$65,958	49.5
4100	2,849	853	$62,364	48.3
4101	2,679	688	$36,944	75.4
Total	35,981	9,228		

Units of Insurance Coverage Per Family	State Farm Percentage Of Available Coverage	Families Per State Farm Agent
.88:1	22.6%	-

Source: The California Department of Insurance, the 1990 United States Census and FannieMae

Investment Redlining

The property and casualty insurance business plays a major role in keeping the American economy moving. Insurance coverages backstop the extensive commercial and consumer credit system of the nation. Further, surety bonds are required on almost all public works and commercial construction, to protect against loss in the event a contractor fails to fulfill a contract.

In large part because of insurance coverage, Americans -- business owners and employees, home owners, and car owners -- have more financial protection and a greater sense of security than any people anywhere have ever enjoyed in the history of the world.

Firms in the United States insurance industry are primarily known for their activities in the provision of indemnification against economic loss. However, a significant amount of the income of firms in the insurance industry is derived for two other activities -- financial intermediation in the U.S. credit market and management of pension funds.[1]

---

1 A Descriptive Analysis of the Insurance Industry in the United States, A Report by the Subcommittee on Policy research and Insurance of the Committee on Banking, Finance and Urban Affairs House of Representatives, One Hundred Second Congress, March 1991, page 1.

Table 3: Lending of Private Sector Financial Intermediaries in the United States, 1988 [2]

Institution	Net Flows $ Billions	Market Share
Depository Institution		
Commercial Banks	$155.3	28%
S & Ls	86.3	15%
Mutual Savings	17.8	3%
Credit Unions	16.3	3%
Total	$275.7	49%
Insurance Sector		
Life Insurers	$102.3	18%
State Pension Funds	34.6	6%
Private Pensions	31.4	6%
Other Insurers	29.7	5%
Total	$198	35%
Other Financial Institutions		
Finance Companies	$ 39.2	7%
Mutual Funds	11.9	2%
Money Market Funds	10.7	2%
Other Financial Institutions	25.7	5%
Total	$ 87.6	16%
Grand Total	$561.2	100%

The importance of the insurance industry in financial intermediation cannot be too greatly stated. Insurers depend on income derived from the

[2] A Descriptive Analysis of the Insurance Industry in the United States, A Report by the Subcommittee on Policy research and Insurance of the Committee on Banking, Finance and Urban Affairs House of Representatives, One Hundred Second Congress, March 1991, page 44.

their activities as financial intermediaries to generate profits and cover such losses as may result from their insurance underwriting activities. Because of their large holdings of unearned premium reserves and loss reserves, insurance companies represent a major source of funds for U.S. credit markets. Forty-six percent of the financing for domestic corporation and foreign bonds on 1988 came form the insurance industry. For the same year, seventeen percent of U.S. Treasury securities were purchased as investments by insurance firms, and twelve percent of all mortgages held by private financial institutions were financed with funding from life insurance firms [3].

Total income of all U.S. property-casualty insurance companies in 1989 was $11.2 billion. Property-casualty companies lost $20.4 billion on their underwriting activities in 1989, while investment profits were $30.5 billion. [4] Investment in U.S. credit markets by property-casualty insurance companies totaled $444.7 billion in 1988, making property-casualty insurance companies the six the largest of private domestic institutional sources of funds. [5]

Fifty one percent of property-casualty assets in 1988 were invested in tax-exempt securities, with 98 percent of all assets invested in securities of all types.

For the most part, insurance companies have been relatively free of control over the types of investments they can make. Most of the investment regulation insurers face is the requirement that they be able to demonstrate to

[3] A Descriptive Analysis of the Insurance Industry in the United States, A Report by the Subcommittee on Policy research and Insurance of the Committee on Banking, Finance and Urban Affairs House of Representatives, One Hundred Second Congress, March 1991, page 45.

[4] 1988-89 Property/Casualty Fact Book, page 22.

[5] Insurance Information Institute, ISO, NAII Report Full Year 1989 Property/Casualty Industry Financial Results, Insurance News, March 26, 1990.

a State insurance regulator that their investment portfolio is not so risky that it is likely to cause problems with solvency. The portfolio must also be sufficiently liquid to enable the insurer to meet claims in a timely fashion even if the final markets takes a down turn, as the stock market did during the fall of 1987 and the fall of 1989, or if the volume of claims made suddenly increases, as might occur during a natural catastrophe such as Hurricane Hugo or the Loma Prieta earthquake in 1989.

While property-casualty insurance firms are, like life insurance firms, relatively unrestricted in their investments, their investment appear to be responsive to the need to hold relatively liquid assets which can be marketed readily if actual claims exceed those predicted. Thus, property-casualty firms hold approximately 78 percent of their assets in tax-exempt bonds and Federal Government bonds (U.S. Treasury and Federal agency securities). The remaining 22 percent of their assets are placed almost entirely in corporate and foreign bonds with a negligible proportion placed in mortgages.

Again I would like would like to again use my community, our community here in East Oakland, to put in context an example of the investment needs of the urban community. As detailed in my 1992 Report, *Credit and Capital Needs in Central East and East Oakland* , East Oakland has a home ownership and home rehabilitation loan requirement of approximately $57,000,000 per year and a community based business loan requirement of approximately $250,100,000 per year. In addition we need to underwrite an community based business equity capital pool of at least $5,000,000. This funding is required to put our community back on a strong economic footing, generating community wealth..

I can almost guarantee you that none of the top ten insurers in the State for California's assets have found their way into East Oakland or any

other historically underserved community in California. THIS IS INSURANCE INVESTMENT REDLINING and is bad public policy and must not be allowed to continue.

I am pleased to inform you that our Insurance Commissioner, John Garamendi has put insurers on notice of his belief that as a matter of public policy insurers have a responsibility to make sound investment, including investments in persons of color owned businesses and historically underserved communities, in a non-discriminatory fashion for the good of our local and national economy. The California Department of Insurance has also determined that the California Insurance Code as currently configured allows for investment in persons of color owned businesses and historically underserved communities. And the Foundation with the assistance of the Commissioners has introduced to the National Association of Insurance Commissioners a framework in which safe and sound investment can be accomplished, monitored and controlled by regulators.

Part Four: H.R. 3298 Provides One Of the Three Necessary Community Revitalization Tools That Can Be Provided by Insurers

Item One: Increase Persons and Communities of Color Access to Insurance Product

Agency Appointments

The residents of the urban core must find a way to compel the insurance industry to create a mechanism to increase the number of community based, of-color and women owned insurance agencies and

brokerages must be negotiated with the major national carriers. This because these agencies and brokerages would be in the best position to achieve the concurrent goals of making sure the community has access to insurance products and making sure the the best possible risks are booked for the insurers.

Insurers should develop apprenticeship programs to help develop future agents, mentoring and technical assistance programs for new agency appointments, and develop a investment pool to help capitalized new agencies.

<u>Item Two: Assist in the Creation of Capital for Of-Color Community Economic Revitalization</u>

An Urban Economic Empowerment Mutual Fund

Using the successful model of private sector funds, we must create a traditional mutual fund specializing in enterprise zones with the charter to invest in any of the local, state or federal designated community development financial institution or growth oriented person of color owned business or business located in community empowerment zones nationwide whose employes are 60% or more residents of the community.

Investors would receive market rates of return from a managed, highly diversified portfolio of debt, convertible, and equity securities of profit-seeking businesses willing to locate within community empowerment zones.

The availability of capital from this specialized source would augment federal and state tax and job training incentives.

Like investment funds dedicated to environmentally sensitive uses, the Urban Economic Empowerment Mutual Fund should appeal to socially motivated investors with fiduciary responsibilities including pension funds, foundations, churches, charitable organizations, individuals and insurance companies.

Launching such a fund requires the specialized management servicing capabilities of a major asset manager. In order to induce the launch, seed money investments might be pledged by prospective investors in sufficient amount to allow the fund to break even from inception.

The sponsorship of such a fund might also be a low cost and highly visible way for an asset manager to contribute to a solution to the urban crisis while potentially benefitting from developing new asset sources.

B. Community-based Property Reinsurance Company

We must find a way to create a community-sponsored reinsurance company as an investment and risk-taking vehicle for local capital. As a means of attracting outside businesses and investment, the community could develop an insurance fund for the sole purpose of mitigating the risk of deliberate future property damage.

Because residents would have an ownership stake in the fund and thus put community capital at risk, the community could market such reinsurance not just as fund for claims recovery, but more importantly as the financial embodiment of the residents' commitment to actively promote a safer business environment.

Traditional property insurance would provide conventional coverage with the community-sponsored reinsurance available only to indemnify for

deliberate damage to the insured premises. Local investors -- including individuals and institutions -- would pool their money for common investment and as a reinsurance reserve. So long as deliberate property damage were avoided, returns on the capital pool would be available for reinvestment and a compounding return.

Launching the reinsurer would require actuarial assessment, portfolio management, investor solicitation, marketing, premium collection, and claims-paying services.

Capitalization could come from donations, debt and equity investment drawn from outside the community, private placement of debt within the community (churches and other community organization as well as individuals, a legislated insurance premium surcharge, and the stand--by pledge of securities from pension funds.

Critical local participation could be initially boot-strapped by granting residents equity participations in the pool in return for labor contributions to community development projects. Withdrawals of capital created through such "sweat equity" would be prohibited. However dividend payments would be made after a specified holding period.

The reinsurer would not be seen as competitive to existing insurance providers because they would continue primary insurance in accordance with their own underwriting standard, pricing, and servicing constraints.

C. Assist in the Underwriting a Persons of Color Owned Property and Casualty Insurance Company

Currently there is not a single African American owned property and casualty insurance company in the United States. As such, one of the above

mentioned investment strategies should be implement in an effort to raise the minimum $6 to 10 million in capital needed to launch such a compa:.y. Such an organization will also need a stable of reinsurers to help spread its risk. The existing reinsurer network could be tapped to provide not only reinsurance but subordinated debt as well.

Item Three: H.R. 3298

The National Property Reinsurance Act provides a mechanism to assist those insurers already in the marketplace who genuinely what to make money serving our communities by providing them with a reinsurance mechanism.

Part Five: Summary of H.R. 3298 Benefits

1. Would a greater availability or access to reinsurance encourage insurers to return to these underserved inner-city areas?

Yes

2. What level or mechanism of a reinsurance incentive would encourage insurers to resume insuring inner-city risks?

Because we are basically dealing with racism, it is very hard to find an incentive to combat it. However what H.R. 3298 can do is offer sincere insurance a measure of protection as they learn more about us and start come back into our communities.

3. What are the benefits of H.R. 3298 not addressed by the current federal crime insurance program?

The Federal Crime Insurance Program offered but on mechanism: crime protection. Additionally it is a primary insurance vehicle and not reinsurance. Essentially it tended to isolate the urban consumer from the regular insurance marketplace.

4. How would H.R. 3298 affect the affordability and and availability of commercial and property insurance.

As I outlined in part four above reinsurance is but one of an array of mechanism that can lead to the revitalization of historically undeserved communities.

Additionally if Congress is prepared to bail out the insurance industry for its mismanagement and "over" underwriting in communities prone to identifiable foreseeable natural disasters such as hurricanes and earthquakes in white upper income communities, via the Natural Disaster Mitigation, Relief, and Insurance Act of 1993; does not Congress have the duty to protect consumers in the urban core who suffer the effects of the unnatural disaster of racist underwriting?

The only fault I find with the bill is that in Section 1225(c), National Property Reinsurance Fund, Investments, you limit the investment of surplus to only United States obligations. I have attached at appendix A my argument that all entities involved in the management of insurance portfolios should diversify their investments throughout the entire economy, including investments in historically undeserved communities.

Part Six: Conclusion

In closing I will tell you that obtaining access to the economic resources which can lead to the economic empowerment of of-color and low-to-moderate income communities, single women and community based micro-businesses is the last frontier of the Civil Rights movement in the United States. The Economic Empowerment Foundation is dedicated to conquering at least a small portion of this uncharted territory.

We need the support of government in our efforts. The activities in which the Economic Empowerment Foundation is engaged and are intended to enhance the human dignity of the communities we serve by providing support for community members to exercise personal responsibility and participate actively in determining the course of their own lives and the lives of their community. In a capitalistic society in our American society, controlling ones economic destiny, including reasonable access to property insurance, is the cornerstone of human dignity.

Thank you for your attention.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct to the best of my knowledge. Executed in Oakland, California, on May 18, 1994.

Selwyn Whitehead

Trading Diversification for Discretion: An Antidote for the NAIC Pigeoned Holed Model Investment Law

by

Selwyn Whitehead and Herbert Whitehouse

Abstract

Diversification is prudent. A set of pigeoned holed investment criteria that precludes diversification into a truly efficient portfolio, is imprudent. Insurance company investment managers need both the impetus and the discretion to diversify. We propose that the NAIC require the necessary diversification; but that it permit the discretion necessary to obtain a diversified portfolio. In other words, we propose that the NAIC, through its Model Investment Law, trade diversification for discretion to yield that illusive **"acceptable middle ground"** *between the untethered "prudent person" and the micro managed pigeoned holed investment management techniques.*

The theoretical risk/return foundations of the NAIC asset allocation model can not be supported. Academic research is now placing the foundation of the efficient market hypothesis (EMH) -- the Capital Asset Pricing Model (CAPM) and Beta -- in doubt. As the reader progresses in this proposal it will be important to understand the investment managers who largely determine the allocation of institutional investor investment capital have for the last two decades, relied on the proposition that the expected return on a portfolio should exceed the riskless rate of return in a manner that is related to the portfolio's beta, or correlation to the overall market's total systematic risk.

An investment skew biased against inner city and small business investments is an inefficient portfolio. The CAPM in measuring the risk of a portfolio, has as its theoretical underpinning the relationship of a portfolio's risk and return to a true market portfolio consisting of all assets, which was also, by definition, the most efficient portfolio, In practice, however, portfolio managers have ignored this fundamental risk/return and diversification conclusion. Instead institutional investors have chosen to largely exclude the entire non-market segments of our economy from their investment portfolios, including those sectors of our economy represented by the inner city and small business.

Insurance companies, by their very act of redlining inner city communities out of their investment portfolio create a risk that would not exist if our communities were not redlined. If the academic crises regarding CAPM and the EMH has any influence at all on the direction of our fundamental political economic structures, it will be to encourage those who have argued that markets are embedded in, and are currently influenced in a very significant manner, by the institutions of a society -- including the economic institution that most relies on the theoretical freedom of markets from such influences as

the basis for its own allocation of resources decision making: viz., the institutional insurance company investor.

The insurance industry needs to avoid what has become the "man on the street" perception of insurance company risk; namely, that "my pension is only at risk if it is insured"; and if it is insured I hope it is in a separate account so that it will be invested properly and be free from typical insurance company risk. Without proper discretion to match its portfolio to its liabilities the only insurance company business that will continue to grow will be its separate account business. Even "riskless" investments may be very risky relative to the liabilities that an insurance company has to cover. For example, short term treasuries that do not have interest rate risk are not appropriate for funding long term liabilities that will move with interest rate changes. Each insurance company, therefor, must be given the flexibility to set up its own asset allocation, unconstrained by the pigeon holes of the NAIC proposals. However, what the NAIC must do is to establish standards that set forth a *level of confidence guideline*. This guideline will establish how sure the insurance company must be that liabilities will be covered over an extended time horizon. As the degree of confidence required increases, insurance companies will be required to have a very precise cash flow matches to its liability stream, reduced default risk using both diversification and quality criteria, investments without volatility risk unrelated to the volatility of the liabilities, and/or higher reserves. However, within one simple confidence guideline, the insurance company can be free to adjust the various factors that go into meeting that standard.

Investment policies skewed around large national corporations denies our economy the productivity of small business and persons of color owned businesses. To ensure that investment policies are meeting the needs of the economy each insurance company should work with the insurance commissioner or the governor of the state in which it is doing business to obtain an understanding of the economic and investment needs of that state and should, to the extent that it can also meet its required overall confidence guidelines, assist the state in reaching its economic goals by assisting in the development of innovative investments that create capital for small and of-color business and inner city community economic development. The attached White Paper outlines the rationale for this cooperative investment approach.

Perhaps the greatest symbol of corporate international power is the IBM corporate headquarters in Armonk New York. On Thursday, January 13, 1994, the front page of the New York Times reported that IBM was considering abandoning its headquarters – a building "best suited to serving as the palace of a corporate kingdom."[1]

For a quarter of a century, IBM had dominated the world computer industry. Armonk represented more than just the largest computer company in the world. It was indeed a "corporate Kingdom," and operated with substantial sovereignty and independence. Like many other American multinationals, IBM even operated its own foreign affairs. IBM didn't just dominate the world computer market; but it managed its own colonial empire with thousands of employees in manufacturing operations all over the globe. American's large corporate empires have been operated largely independent of government direction; and they set their objectives in splendid isolation from any national policy or other cooperative American agenda. However, that is not to say that these policies were being set in opposition to United States government policy. Corporate independence was our national policy.

Despite their size and preeminent market positions, American corporate strategies were designed to maintain a position of dominance, not for global competition. The need for these once dominant corporations to "reinvent themselves" caught many Americans by surprise, including the portfolio managers for America's institutional investors, who held 60% of the stock of America's largest companies in 1990.[2] Like many American corporate giants IBM not only had an aura of self-sufficiency, but of permanence. But that aura is gone. And IBM is not alone. As the New York Times went on to note, "regal tenants are in dwindling supply." Ironically, it was their very independence from society and government that now denied them an advantage the new global competition was bringing to the market place; namely, the teamwork, cooperation, and planning of entire nations or city states.

That coordination and mutually supporting institutions are key differentiating features of these disciplined economic competitors has been well documented.[3] If we have recognized the elements of global economic success

---

1 Steve Lohr, "I.B.M. May abandon Its Hilltop Headquarters," New York Times, p.1, January 13, 1994.

2 Dr. Carollyn Kay Brancato, Institutional Investors and Capital Markets: 1991 Update, Columbia Institutional Investor Project, Center for Law and Economic Studies, Columbia University School of Law, (September, 1991). This study also indicates that by 1990 over half of Business Week's top 1000 companies had over 50% of the their equity held by institution investors, up from 45% just three years earlier.

3 See Robert Kuttner. The End of Laissez-Faire: National Purpose and the Global Economy After the Cold War, Alfred A. Knopf (1991) (Suggests that "devotion to laissez-faire... impedes the tasks of defining our strategic goals in the world, [and] restoring our own economy to health."); George C. Lodge, and Ezra F. Vogel; Ideology and National Competitiveness: An Analysis of Nine Countries, Harvard Business School Press (1987) (Concludes that the "communitarian" policies have Germany and Japan an edge in world competition; and suggest

why don't we act on that knowledge? Some claim that our democratic government lacks the will to reorganize our political and economic institutions to deal with global economic change. Others remind us that very powerful governments often fail in their attempts to create better and more prosperous societies. But economic realities keep pressing for a response. Our current economic organization, despite its heard start, is struggling to compete with many better coordinated and better organized economies. Nonetheless, we hesitate. And we hesitate not because American business does not know what it takes; but because it takes the kind of cooperation that only comes from the coordinated efforts of an entire society -- cooperation and coordination that by definition will be lacking if attempted by business alone. And that means government integration, and the revision of a financial and investment structure build around, and designed to promote, the independence of large national corporations like International Business Machines.[4]

---

that America's individualistic business ideology is too strongly ingrained into our culture for us to change.); Michael E. Porter, ***The Competitive Advantage of Nations***, the Free Press (1990) (Especially not Porter's emphasis on clustering and regional economics in creating competitive advantage. Porter's prescription is based on an identification of competitive industrial clusters around the world. Primarily it suggests that regions will tend to be successful when they pul in industries related to their existing strengths -- the region can not compete globally if it allows one corporation to eliminate competition at home. Porter also describes a controlled branching process in successful economies that limits growth to related, and mutually reinforcing industries. Because these competitors are regionally clustered, and functionally related, regional governments can effectively provide support. Moreover, Porter suggests that it is the very existence of diversified competition in regions that allows a natural process of cooperation, mutual support, and interaction among the related regional firms to develop and enhance the global competitiveness of the entire region vis a vis world competitors.).

[4] But our hesitation is not uniform. It is primarily a hesitation of our national corporations and the national institutions built to serve those corporations. At the state, city and regional levels, public and private partnerships, for the very purpose of creating Michael Porter's competitive regions are already becoming the nexus of our new global economy. See Gary r. Severson, "IT'S TIME TO RESTART THE GLOBAL ENGINES -- PUGET SOUND BUSINESS MUST FORGE ALLIANCES TO BETTER COMPETE IN A TOUGHER WORLD ECONOMY, ***The Seattle Times***, September 5, 1993, Sunday, Final Edition ("Whether we like it or not, we are all a part of the global economy.... Author and urban essayist Jane Jacobs was right. She has long held that cities are the turn source of energy in national economic life. Along with Michael Porter, Kenichi Ohmae and Neal Pierce, she has argued that policymakers need to pay more attention to the economic development of city-regions. One of the fundamental conclusions of the National League of Cities' 1990 report, "Toward a New Political Economy of Metropolitan Regions," was that metropolitan economic regions are the fundamental components of a dynamic system of national economic regions.... In other regions of the world, people have long been organizing themselves to be more competitive in the world economy, and we need to catch up. Taiwan is a good case in point. Last year, Taiwan's vice minister of economic affairs led a business mission to Seattle in search of business partners for Taiwan's $300 billion national development plan. Together, Taiwanese business and government have identified 10 industrial sectors for immediate development, ;including aerospace, environmental industries, telecommunications and computers. These priorities complement Taiwan's ongoing investments in marine port and airport facilities, rail and roads and other infrastructures. It is a coherent strategy orchestrated by business and government together. The Kansai region of Japan, which encompasses the cities of Osaka, Kobe and Kyoto, has developed a plan to transform itself into

The reasons for our reluctance to change go very deep and reach down to the fundamental folklore and shared values of our American tradition. We value freedom; both market freedom and political freedom. We will not suffer government oppression. We don't trust government; and we don't believe that government is efficient. We had also believed that a free market was efficient, and that it provided the best possible allocation of capital and wealth. These are principles that will not be overcome by any mere academic theory or debate, or by reference to an alternative political economic model.[5] The

---

one of the most important economic regions of the world in the 21st century with an infrastructure development project nearly the size of Taiwan's. With a new airport on a man-make island in Osaka Bay, a new Science City, and other extensive port and municipal projects the new "Kansai Global City" will rival Tokyo as the commercial center Japan. A study mission from Seattle will visit the Kansai region next year. Other cities and regions have the organizational structure in place to promote themselves. In Amsterdam, an organization called AmPro promotes the city in international markets. the Hong Kong Trade Development Council has an enormous budget, funded in large part by a port levy, to promote Hong Kong. Nowadays, companies have to compete not just within their local area, but nationally and internationally. We now find ourselves in a new game in which other teams are playing by different rules. So... our communities must develop strategies, partnerships, approaches and smart investment plans to compete. Changed circumstances require new thinking. Metropolitan regions are the building blocks of our nation's economy. The problem is that our regions generally lack the governance mechanisms to make to the important investment decisions for our scarce public capital. I'd like to make four major points today:

1. The competitive position of this country in the world economy has changed dramatically in the past two decades, and the consequences of this are only just beginning to be understood.

2. Metropolitan economies are important to future competitiveness. And there are a number of specific actions that ca be taken by the public sector to enhance that competitiveness. In other words, public-sector decisions can make a difference. This is already happening in other regions of the world.

3. Local government official play an important role in ensuring a region's competitiveness.

4. Our partnership at the Trade Development Alliance between the King County government, the city of Seattle, the Greater Seattle Chamber of Commerce, organized the Port of Seattle, modeled after European and Asian organizations, is an example of one small step that can be taken.

Gary R. Severs is Area President, First Interstate Bank of Washington and chair, Trade Development Alliance of Greater Seattle. This article is adapted from an address presented at the annual meeting of the National Association of Regional Councils, Portland, Oregon, June 22.")

5 Academic research is now placing the foundations of the efficient market hypothesis (EMH) – the Capital Asset Pricing Model (CAPM) and Beta – in doubt. As the reader progresses in this White Paper (see supra, at notes 6 and 40 - 48, and accompanying text) it will be important to understand that the investment managers who largely determined the allocation of institutional investor investment capital have, for the last two decades relied on the

solution to global competition will have to come from our own values, and our own strengths.[6]

Moreover, freedom as a shared American value, represents a strength, not a weakness. It represents flexibility and ingenuity. In fact, at its core, it represents democracy -- the participation of the whole society in the decisions of the nation. Our democratic institutions are an underutilized American resource, uniquely ours, and immediately available to give us a superior infrastructure implementing the cooperative spirit that our global competitors have been able to utilize so effectively. The key issue for our society, therefore, is to determine whether the splendid isolation represented by Armonk -- the corporate headquarters on a suburban hilltop -- is essential to our core values and to our political economic system. Or, alternatively, is the separation of business and government merely folklore -- an incidental idea that attached itself to and now stands in the way of our core values - and not essential to providing a full freedom to American ingenuity, flexibility, and democracy.

---

proposition that the expected return on a portfolio should exceed the riskless rate of return in a manner that is related to the portfolio's beta, or correlation to the overall market's total systematic risk. Further, the CAPM in measuring the risk of a portfolio had as its theoretical underpinning the relationship of a portfolio's risk and return to a true market portfolio consisting of all assets, which was also, by definition, the most efficient portfolio. In practice, however, portfolio managers have ignored this fundamental risk/return and diversification conclusion. Instead institutional investors have chosen to largely exclude the entire non-market segments of our economy from their investment portfolios, including those sectors of our economy represented by the inner city and small business. See Gordon and Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761 (1985) ("[T]he efficient market hypothesis cannot be tested in a straightforward way. [Every] test of EMH also assumes some particular theory of what the 'right price' for an asset is. These asst pricing models establish the benchmark of 'normal' returns in order to determine the efficiency of;the market. Consequently, every empirical test of the efficient market hypothesis is a 'joint test' of both the hypothesis and an asset pricing model"); and see Fama and French. The Cross-Section of Expected Stock Returns, 47 J Fiance 427 (1992) (Indicating that "[O]ur tests do not support the most basic prediction of the [CAPM], that average stock returns are positively related to market [betas]."). Compare The Wall Street Journal, October 23, 1987, dismissing the efficient market hypothesis as the "most remarkable error in the history of economic theory."

[6] If the academic crises regarding CAPM and the EMH has any influence at all on the director of our fundamental political economic structures, it will be to encourage those who have argued that markets are embedded in, and are currently influenced in a very significant manner, by the institutions of a society -- including the economic institution that most relies on the theoretical freedom of markets from such influences as the basis for its own allocation of resources decision making; viz., the institutional investor. See Whitehouse, How Pension Investment Policy Drains American Economic Strength, ***Columbia Journal of World Business***, Columbia University, (1992) ("It should be no surprise that the implications of this new institutional force have been only dimly perceived. Even fiduciaries and institutional investors have not yet appreciated the nature of their new role. Fiduciaries still believe that their efforts at investment management are analogous to the efforts of a sailor trying to catch the best winds and currents. I propose that his belief is fundamentally wrong. Today, the tremendous size of pension capital means that fiduciary decisions determine the direction of our economic currents. When the fiduciary rudder swings to better catch an economic current, it is not just the pension ship that changes direction, but rather , the direction of the very current on which the ship is riding.").

This issue will not be decided on a theoretical level. Rather, America's solution to global competition will flow from real world exercises in business organization and in the integration of economic objectives into the purpose and activities of government. It is these concrete exercises in integration, that will, as they add diversification and freedom and flexibility, form the basis of a reintegration of government initiative and entrepreneurship with the fundamental (folklore free) principles of our democratic society's political economy.[7] Massive centralized bureaucracies, whose organizations were built around, neither competition nor cooperation, but market domination and self-sufficiency are in decline.[8]

Smaller companies and those built around different economic models are capturing market share from the retrenching old regime.[9] These companies

---

[7] One such exercise in integration has taken place in Raleigh/Durham over the last decade or more. In its November 15, 1993, issue *Fortune* magazine picked Raleigh/Durham as the best U.S. city for business. (See "The Best Cities For Knowledge Workers.") *Fortune* says this about the site of the nation's most famous business cluster, Research Triangle Park: "What makes the part work so well is a unique nexus of the business community, area universities, and state and local governments." But this clustering and cooperation wasn't created by invisible market forces. North Carolina Technological Development Authority (TDA) worked very actively with Research Triangle Foundation and Research Triangle Institute, and the Southern Technology Council (STC), to boost technology in the region and to promote "regional centers of excellence." In line with the themes to be described by Michael Porter several years later was a focused public/private corporation, the Microelectronics Center of North Carolina (MCNC), whose president, along with the TDA's director represented North Carolina on the STC board. The MCNC was organized to help spread research and development costs. It brought in $250,000 in cash or equipment from participating business for three years in exchange for the ability to use the MCNC research facilities and to use products generated at the cent for free. (A one time royalty fee was required to bring a product out into the open market.) by 986, North Carolina had spent $75 million on the center and was spending as much on the MCNC as on "all other economic development programs within the Department of Commerce — industrial recruitment, small business development, the technological development authority, foreign investment, export development, international trade center, the film office, tourism,the seafood industry and administration." The Director of the STC was asked whether the investment was worth it. His answer: "Six years is too noon from the initial investment to know whether it's going to pay off; ten years seems more reasonable to me as to whether it is going to produce jobs and investments." (Bill Finger, Can North Carolina Cash in Its Big Bet on High-Tech? *Business Dateline*, Vol 6; No 11 (November, 1986).) Similar state funding was provided for a biotech research center which has helped 43 companies stare in the past five years. None of this effort paid off overnight; but by November 1993, a pattern of public and private cooperation had set in to such an extent that *Fortune* would call Raleigh/Durham "the model of the metro region geared to the rules of the new economic game."

[8] See Robert Reich, The Work of Nations, and Kenichi Ohmae, the Borderless World. Both Reich and Ohmae effectively challenge many of the long-held premises on which America's national corporations have justified the use of national economic policies as a means to restrict freedom, diversification and competition.

[9] See David Friedman, GATT'S PROMISE CAN ONLY BE REALIZED IF FOLLOWED BY TOUCH REGIONAL POLICIES; TRADE: WITH U.S. BUSINESS THE POSSSIBLE BIG WINNER, CLINTON MUST REWARD THOSE COMPANIES LEADING TH WAY, NOT RETURN TO DEMOCRATIC POLITICS-AS-USUAL, *Los Angeles Times* (December 19, 1993)

are not only spreading risks and expenses for each other; but they are working in partnership with state and local governments who are providing infrastructure, reliable financial support, and even direct business support.[10] Moreover, this new pattern of political economic cooperation is being replicated, to a greater or lesser extent, in thousands of communities.[11] All

("Unnoticed by many observers, including top Administration economic officials, the global economy is undergoing an epochal shift... In the 1970s and '80s, the bureaucratic businesses and labor unions that dominated the u.S. economy were outflanked by nimble German, Japanese and other national producers that developed creative, flexible alliances between larger and smaller firms and sustained high-value-added, high-skill manufacturing capabilities. U.S. companies hardly acquainted themselves well in response to this competition.... But n the wake of decades-long layoffs, bankruptcies and other forms of "restructuring," U.S. business is becoming more adaptive than its rivals. Not only did many U.S. companies learn the quality-control and inter-corporate practices perfected by their overseas rivals, but the U.S economy, virtually alone among major economic powers, managed to sustain an entrepreneurial culture that continuously created new enterprises to replenish the nation's industrial base as the older one retrenched.")

10 The biotech industry is a key example. New Jersey is a magnet because of its pharmaceutical industry and also because new jersey firms can maintain close ties with New York City's world class academic medical centers. Long Island has grown its biotech companies around Stony Brook and the genetic research capabilities of Cold Spring Harbor Laboratory. but New York City itself, while it manages to be an incubator and to held the surrounding region new Jersey, Westchester, and Long Island) which directly employs some ,500 people in biotech, the city itself has fewer than a dozen biotech companies employing fewer than 200 people. According to Thierry Noyuella, deputy directory of the economic research focused Eisenhower Center, at Columbia University "New York's biggest economic problem may be not so much the loss of the headquarters of very large corporations, but rather the tendency of smaller firms that are born here to leave." See Tom Redburn, New York struggles to Lure Coveted Biotech Labs, *The New York Times* (December 15, 1993)(Ten years ago, the state established a biotechnology center on the Stony brook campus, which receives about $1 million a year to promote collaborations with industry and the transfer of academic research to biotech companies. The center will spend another $3 million to expand. As a result, Long Island has become home to more than 30 biotech companies employing more than 3,000 people. These include companies like BioCogent (founded by a Stony Brook faculty member), Curative Technologies (lured from out of state by the incubator), and Olympus Biotechnology Development Center, a spin-off of the Japanese-owned Olympus Corporation."). Other regions are also focusing on biotech including Massachusetts, Rhode Island, San Diego, North Carolina, Montgomery Country, Maryland. The San Francisco Bay Area alone employs 20,000 people in the industry. See Id. ("[S]tate governments in California and Massachusetts have helped cultivate growing biotech clusters around San Francisco and Cambridge. Cambridge and Massachusetts, for example, have already helped build a major real-estate project to house new and growing biotech companies, and they have made extra efforts to cut thought institutional red tape for the industry. Similarly, California has provided extensive financing for biotech companies to settle in South San Francisco, once the home of thousands of traditional manufacturing firms that have abandoned the city or gone out of business. Compare Bradley J. Fikes, City May Consider Building Incubator for Baby Biomeds, *Business Dateline* (December 14, 1992) ("San Diego may build a biomedical incubator center to nurture start-ups under tentative plan by the San Diego Economic Development Corp.... Intended for very small companies with about $250,000 in working capital... the not for profit incubator would provide lease space at cost.").

11 Even a decade ago industry was beginning to notice and to categorize state economic development activities and programs state by state. See States Luring Foreign Technology

states, and according to the National Council for Urban Economic Development, nearly all cities with a population of over 500,000 have had a substantial economic development agency for at least five or ten years. The infrastructure for state and local government participation has already been built.[12] Principles of political economy are being established day by day, not

---

Firms, *Aviation Week and Space Technology* (September 3, 1984) (Comments provided to the industry illustrate a variety of strategies region by region. The description of government activity in the Atlanta region included these comments: "Following a mission to Dusseldorf last year, 30 West German companies made plans to locate in the Atlanta metropolitan area. Foreign investment, primarily in the Atlanta area, is over $2.5 billion and is expected to grow. A German Trade Center is one of 23 consular of trade offices located in the city. Businesses targeted by the state are military electronics, software, telecommunications, biogenetics, microelectronics, robotics and alternative energy sources." On the other hand Missouri's focus was on sales offices and warehouses, presumably to leverage its central location. The Indian Department Commerce's Industrial Development Division was reported to be "mostly working with electronics and automobile producers in Japan." The report on North Carolina again showed a focused approach: "The state Commerce Dept.'s International Div. is trying to move away from textile, furniture and tobacco toward other business except minerals but including aircraft, according to James R. Hinkle, division director. Te state offers industrial revenue bonds but not tax concessions or financing with state appropriations. The divisions competed for the $30 million Rolls-Royce turbine disk machining plant that wound up in Miami during 1982. The Research Triangle Park area with nearby North Carolina State University and Duke School of Engineering has ben a magnet for companies...").

12 A quick survey of public and private agencies in the State of New Jersey clearly indicates that, whether or not formal political economic theory has kept pace with the practical activity, at least the practical foundation is in place for a formal recognition of the public nature of economic development. The following review is largely taken from *Crain's New York Business* (December 6, 1993):

New Jersey Division Division of Economic Development, Office of Financial Management Assistance promotes foreign investment, identifies public and private sources of capital and matches available partners for investment, joint venture, mergers and acquisitions. The New Jersey Economic Development Authority issues Economic growth Bonds to finance business expansions and improvements at attractive interest rates. I issues Tax Exempt Bonds for 501(c)(3) non-profit facilities and certain "exempt facilities," such as solid-waste disposal, gas, electric and water facilities. Taxable bonds can be used for a wide range of business uses including – but not limited to – manufacturing, industrial, commercial and service projects. The minimum loan is about $750000, and the borrower must make an equity contribution or at least 10% of the project financing. Bonds may also be issued in the public marketplace or privately placed to individual projects; typically the minimum loan is $1 million. Loans for both fixed assets and working capital are available through the Statewide Loan Pool for Small business, which is funded by the state EDA and a group of New Jersey banks. There are two financing structures available depending on amount being sought. Loans under Tier I range from a minimum of $50,000 to $1 million for fixed assets and up to $500,000 for working capital. One of the participating banks provides 75% of the loan while the EDA provides the remaining 25% on a subordinated basis. The authority may also guarantee 25% of the bank portion of the financing. Under tier II, loans range in excess of $1 million up to $3 million and can include both fixed-asset and working capital, as long as the latter does not exceed $500,000. The EDA provides up to $250,000 and may also guarantee up to 30% of the bank's exposure. The Maximum term for loans under the program is 10 years. Borrowers benefit from a blended interest rate. The rate on the bank portion is negotiated based on market conditions and the term of the loan, while the EDA portion is set at the federal discount rate, but no lower than 5%. To be eligible

by academics, but through real world interaction of government, business, community organizations, and the investment community.[13] To some extent,

---

for consideration, a business mus be located in an economically targeted municipality or represent a targeted industry. Generally, EDA loan and guarantee assistance will not exceed $35,000 per job created or maintained. The agency's loan guarantee, not to exceed 90% of the loan, are offered with maximum $1 million exposure for working-capital loans. The guarantees may not exceed 10 years, although the loan may be for a longer term. The authority's Direct Loan Program provided businesses with loans up to $500,000 for fixed assets and $250,000 for working capital at rates equal to the federal discount rate at the time of approval or closing. The interest rate may not be lower than 5%. Also, the New Jersey Economic Development Authority assists local development corporations, which provide information about the programs described above and other services to businesses. The Division of Development for Small business and Women and Minority Business conducts presentations, training workshops, seminars and offers limited one-on-one counseling in areas of business development and growth.

Major cities as well as country governments have established economic development agencies. The Jersey City Economic Development Corp. offers assistance to new and existing businesses to relocate or expand their operations in Jersey City. As the city's Urban Enterprises one Authority, it certifies eligible businesses for participation in the state's program. JCEDC also assists with the preparation of financing packages and works with local merchants to promote commercial activities. It administers several business loan programs, including a pilot micro-loan program sponsored by the SBA, a small business loan program using money from the federal Economic Development Administration and Department of Housing and Urban Development Administration and Department of Housing and Urban Development, and a city-funding Economic Development Financing fund. Those programs provide for low-interest, fixed-assets or working capital financing up to $100,000 or more for existing business, and up to $25,000 for start-up entrepreneurs. The Newark Economic Development Corp. is a private not-for-profit agency organized to attract, promote and retain business investment. NEDC offers availability information on commercial and industrial development sites in Newark and assistance in the preparation of development plans, as well as guidance on zoning requirements and tax abatements.

Private organizations, in cooperation with the State, cities, counties, and the federal government's Small business Association are also available to assist business. The New Jersey State Chamber of Commerce's publications, conferences, seminars and other programs and activities provide business people with business, governmental and technical information, as well as personal development for executives and employees. It offers specialized assistance in labor and human relations, governmental dealings, taxation, business location and international trade areas. The chamber is also the official Small Business Resource Center for the U.S. Small Business Administration and an associate office of the U.S. Department of Commerce. (The Corporation for Business Assistance in New Jersey provides small businesses with fixed-asset financing up to 10 or 20 years for the purchase of land and building, machinery and equipment, renovation and restoration under the SBA's Section 504 program. The program offers loans up to $750,000 per project (but not in excess of 40% of total project costs).

[13] See ACTING PENNSYLVANIA GOV. SINGEL SIGNS BILL EXPANDING, SIMPLIFYING PEDFA PROGRAM PR Newswire (December 17, 1993) ("Acting Gov. Mark S. Singel today signed legislation that will mean a new source of capital for Pennsylvania businesses, municipalities and public agencies. The legislation, Senate Bill 1126, amends the law guiding the Pennsylvania Economic Development Financing Authority (PEDFA), one of the state's key economic development financing programs. 'Pennsylvania is recognized as a national leader for its comprehensive business competitiveness strategy,' Single said. 'Financing business in vestment across the state is a key component of that strategy, but we cannot retain a

the developing practice patterns coming out of these interactions are so widespread, and so consistent that it already represents the establishment of new principles of government. It is only our political economic thinking that has not fully appreciated the principles underlying this new reality.

The opportunity to help identify these principles to the NAIC is exciting, because the dominate political and economic themes of the next century will revolve around city, regional and state planning. This development will occur, not because of the ideas coming from planners, academics, or political theorists. Rather regional planning will become central because the cities, regions, and states will already have become central to our economy, and to our society in general.[14] That new principles of political economy follow reality and not the other way around can be seen most directly by looking at the proposal being set forth today by conservatives arguing for a revival of federalism.[15] Absent these hands-on economic efforts by the states and cities, conservative proposals for a revival of federalism would appear anachronistic given the national economy and strong federal government that has developed throughout most of the twentieth century. The theory of federalism is a powerful theory of government, and it resonates strongly with America's political sense of right and proper government. Yet power will never flow to the states, or to cities and regions, because of federalism per se. Federalism, as

---

competitive edge by standing still. The bill I'm signing today will make its easier for Pennsylvanian's home-grown firms, local governments and other public agencies to obtain needed capital and finance job-creation and community projects. We're taking an excellent program and making it stronger. PEDFA will now offer a far wider range of assistance to new and growing businesses.' PEDFA was created in 1987 to pool economic development projects statewide into a single, cost-savings bond issue. The new law simplifies and expands project eligibility. Instead of being limited to industrial bond projects or special projects such as airports, the PEDFA program now offers funding for retail, commercial and community projects.") Most significantly the new Pennsylvania law permits PEDFA funds to be used for working capital, and significantly expands the types of financing strategies available include loans, stand-by loans commitments, guarantees, letters of credit and grants.

[14] See e.g., Thad Bayle, Governors in Hard times, p. viii, CQ Press (1992) (In the forward to this collection of articles, Eagleton Institute's Alan Rosenthal writes: "The States are where it is at today, and where it will be tomorrow. And Governors are the principle actor on the scene."); Carl Van Horne, The State of States, p.1, CQ Press (1992) ("Hard economic times nationwide are testing the mettle of state leaders and institutions like never before. State governments arguably were [in 1989] the most responsible, innovative, responsive, and effective level of government in the American federal system. How skilfully the States manage the current crisis will determine whether that characterization will be retained.").

[15] The need for innovation in fast moving global economies is the force pushing the development of regional economic clusters. State and city governments are developing the institutions to create this new approach to business, not out of loyalty to federalism, but out of economic necessity. It is the economic wealth being created out of government establishing the conditions for business to flourish, including cluster, infrastructure, and integrating education with business needs that will change the political balance of power.

a political idea, will revive only after, and because, real economic power is being generated by this level of government.[16]

The same may be said about the problems of the inner city, and any responses to these problems that fail to "transcend the formally governmental." Calls for urban renewal, and the daily calls to address the needs of our cities will continue to lack inherent power until society itself revolves around the inner city, until the cities is the economic engine driving society, creating wealth, and

[16] The new economic trend, however, is taking hold so quickly that economist, such as Riccardo Petrella, director of the Forecasting and Assessment of the Science and Technology division of the European Community are already producing warnings that the new economy is leaving nation states (and whole populations that do not get integrated into the new economy) out of the loop. See Riccardo Petrella, Techno-racism: The city states of the global market will create a "new apartheid', *The Toronto Star* (August 19, 1992) ("The new order taking shape in the world today is not the one imagined by obsolete statesman of the Cold War era. Rather than nation-state weighing in on a new global balance of power, a high-tech archipelago of affluent, hyper-developed city-regions is evolving amid a sea of impoverished humanity. If current treads continue, by the middle of the net century, such national-states as Germany, Italy, Denmark, the United sates or Japan will no longer be the most relevant socioeconomic entities and the ultimate political configuration. Within large integrated zones such as North America, Europe and East Asia. Areas like Orange County California; Osaka, Japan; the Lyon region of France; or Germany's Ruhrgebiete will acquire predominant socioeconomic and political status. Already within Europe, a new web of cooperative institutions has mushroomed among Barcelona, Lyon (which hosts Europe's largest intercity airport), Milan, Strasbourg and Stuttgart - all without passing through a national hierarchy of capitals or central ministries.... The real decision-making powers of the future, it thus appears, will be a network of transnational companies in alliance with city-regional governments. On a global scale, this new order will resemble the flourishing 14th- and 15th-century European economy, which was governed by the Hanseatic cities and intercity alliances that hosed trading guilds and their networking merchants."). See also George Yeo, The advantage of being a city-state (extracts from a speed entitled 'A World of Cities'), *Business Times* (August 21, 1992) ("This is the borderless world which Kenichi Ohmae envision. In such a world, cities become very important because cities are where knowledge is produced. The production of knowledge is a creative process which requires human brains to be stimulated and to be in communications with one another.... In all nations, political power is now shifting back from the national authority to the city. This trend will change the course of history. In China, the dynamism of cities in the South is posing a new challenge to central government. In Europe, the growing power of cites is weakening the nation-state at one level and creating the European Community another because a large framework of pease and stability is needed to promote trade between cites. The same process is happening in the U.S. where the economic decline has affected some but not all cites.... Each city radiates its influence into a larger metropolitan are which may extend into another country. Our Singapore-Johor-Riau growth triangle is only one of many examples in the world. In North America, Vancouver, Seattle and Tacoma are cities in a larger economic area. The Los Angeles area spreads into Mexico. In Europe, the Baltic is becoming one large economic region, so too the Mediterranean Riviera which extends from Spain to Italy. In Asia, many economic regions are forming linking the cites of Japan, Korea, Taiwan and Hong Kong to cities on the Chines mainland. To us the metaphor of the brain, every city becomes a node with synaptic connections to other city-nodes in a neural network which envelops the whole world. What all this means in historical terms is still unclear. We are entering a new era where city-state like Singapore may play quite important roles, where our smallness may well become an advantage.")

controlling the allocation of that wealth. In 1963, Scott Greer recognized this when he noticed that the "morality plays of metropolitan reform," such as urban renewal, had failed "to unite the enormous engines of private corporate enterprise (and their policies) to those of the public enterprise."[17] The recent events in South Central Los Angeles confirm the continued isolation of our inner cities from our national economy. Clearly, our national corporate and investment engines do not revolve around South Central Los Angeles, or Newark, New Jersey.[18]

The questions traditionally asked about these problems by students of government have been political. Should we change our national policies to address the needs of our cities? Should we fight the redlining of these communities out of our national economic life? Should we redirect the investment resources of our economy to ensure a fairer or at least a wider, distribution of wealth? The response to this political question by the defender of our old economic system has been an economic response – leave the free market alone. The closest these responses come to engaging in a political debate is to equate government planning with the totalitarian regimes of a failed communism. Why should we adopt failed socialist planning models when restricting free market operations will obviously weaken the economy?

Unfortunately, both sides engaged in this debate make the same undeclared assumptions found in nearly all standard political and economic texts of the last several decades. The assumptions are basically three: 1) that a free, flexible, and diversified business sphere is conditioned on being separate from government; 2) that business is naturally a non-democratic enterprise unsuitable for management by democratic institutions; and 3) that the primary connections between business and politics (Federal Reserve monetary

---

[17] See Scott Greer, ***Metropolitics***, John Wiley (1963), pp.1-4 (Even noting that city government reformers have always "aimed at the exclusion of ordinary business interest from the motivation of political officials.")

[18] See BANKING ON THE MAN FROM HOPE, Black Enterprise, p. 53, (November, 1993) ("It's easy to identify the top concerns of African-American entrepreneurs: 'Capital, capital and capital,' says Anthony Robinson, president of the Minority Business Enterprise Legal Defense and Education Fund (MBELDEF) in Washington, D.C. 'Access to capital remains issues Nos. 1, 2 and 3 for the minority business community.'" This article reflects, as can be seen from the headline, that the old paradigm of a national economy managed through national policies still governs the political and economic thinking of many. Without recognizing the potential for inner city business that the new paradigm provides, the White Paper goes on to suggest that "the will of the private sector to support minority businesses remains weak. According to the National Minority Supplier Development Council, U.S. corporations spent $ 17.9 billion with minority-owned businesses in 1991, the last year for which data are available. Although that is up from S 15.2 billion in 1990, it is still only about 1% of total corporate spending on suppliers, a percentage which has been unchanged for years. The council notes that minorities account for 25% of the U.S. population, 9% of business ownership and 4% of gross receipts of all American companies." But also see See Selwyn Whitehead, Credit and Capital Needs in Central East and East Oakland, (December 1992). This study, funded by Union Bank, provides documentation of nearly a billion dollars in annual capital outflow from the largely poor and minority sections of Oakland,without *considering the disparate impact of institutional investment practices.)*

controls, the Federal budget, and Federal income tax policy) are mechanisms of national policy for regulating a national economy.[19]

This White Paper, however, presents a challenge to these assumptions. In fact, the theme of this White Paper is that those cities, counties, and states who fail to aggressively incorporate an understanding of basic political economy into their policies; who do not recognize that a national policy built on self-sufficient national corporations will not make a region competitive, and who fail to develop their own region specific economic policies, will fail to survive in this new global economy. But by and large these failures, to the extent they exist, are only matters of degree and matters of transition from one world view to another. Most state and local governments are beginning to play very active roles in the economic sphere. It is only our folklore, and the fact that the global models of economic success have seemed foreign to our traditions, that stand in the way of a general acceptance of a new political economic reality.[20]

Actually, the connections between our democratic traditions and wealth creation are quite strong; it is the folklore of separate spheres that is foreign to our traditions. That fact was brought home to me last November is a surprising way. The national controversy surrounding claims that Christie Whitman's campaign for governor of New Jersey had paid African American ministers "walking around" monies to keep down the inner city vote, generated a surprising question from the ten year old son of my friend and collaborator on the White Paper, Herb Whitehouse. Young master Whitehouse asked his dad whether the New England and southern colonies had poor cities like those today in New Jersey.

Now 1993 happened to be the 300th anniversary of the founding of his home town, Freehold Township, New Jersey; and young master Whitehouse had been exposed to an extra dose of colonial history – enough that a 300 year old world view had generated a fresh inquiry about wealth, poverty, social organization, and democracy in the modern cities of Camden, Trenton, Patterson, Jersey City and Newark, New Jersey[21] (or Oakland, Richmond or

---

19 Congress is also recognizing the role of the states in economic development— in August, Congress agreed to permanently extend a state's ability to issue tax-exempt industrial development bonds for manufacturing projects.

20 Compare Rajendra S. Sisodia, Singapore Invests in the Nation-Corporation, *Harvard Business Review,* p.40 (May 1992/June 1992) ("Singapore's story demonstrates the capacity of a country with almost no natural resources to create economic advantages with influence far beyond its region. It represents one scenario for what can happen when a government assumes an instrumental position in shaping and managing the economic environment. And it underscores the importance of identifying and investing in certain key capabilities. The Singaporean government, though widely criticized for its repressive politics, determined that if it invested enormously in technological and human capabilities, it could create an economy where both individuals and organizations would be more likely to flourish . ")

21 Like other ethnic groups before them who were cut out of the economic mainstream, African Americans seem to have concentrated on achieving equality through the political process. But there does appear to be a new African American focus on using politics, not as an end in itself, but as a means of correcting the imbalances caused by the national corporate economy. See

Compton, California for that matter). A twentieth century controversy had brought out discontinuities relative to the civic ideals he had recently absorbed from his lessons in schools. These are the same discontinuities that will disturb anyone who takes the time to contrasts American economic and political ideals with the realities of inner city life and economic despair.

It turns out that looking at modern politics and economics from this fresh colonial perspective is quite revealing -- and very relevant to the modern challenge of "surviving global economic charge." Our colonial history teaches us, perhaps more than anything else, that there is a strong connection between political empowerment and economic prosperity. Governor Christie Whitman and other governors and all insurance commissioners, would do well to model the great lessons contained in our colonial past. While the models of modern competitors from all over the world are increasingly becoming available to us,

---

Pigeonhole Or Pigeon Trap?, ***National Underwriter*** (December 20, 1993) (This editorial found an African American consumer's views on national investment policy to be preferable to the recommended policies of the National Association of Insurance Commissioners: "[A]n interesting new twist to the investment debate came from a consumer representative who claims to have the backing of the Clinton administration. She urged giving companies discretion so that they could make diversified investments in struggling inner cities and small businesses. Regulators would do well to take notice of what Selwyn Whitehead, president of the Oakland, Calif.-based Economic Empowerment Foundation, said in the whitepaper she presented at the meeting. She pointed out that the model investment law as currently drafted could run afoul of the Clinton administration's desire to direct investments to the inner cities and small business, because it is too rigid and would prevent companies from investing in anything but the highest rated securities. Ms. Whitehead urged the NAIC to take a leadership role in this matter and to make sure the model investment law does not promote "investment redlining." She dropped some rather broad hints both in the paper and in conversation that the tax advantages that have prompted the flood of money into the industry also impose a burden upon it; namely, companies must promote the social and economic welfare of the communities they serve. It does not require a great intuitive leap to see a veiled threat here. Washington has had its eye on the tax deferred inside build-up of life insurance policies for quite a while, and, if Congress started to get the idea that the insurance industry was not meeting its obligations to the community, it could well go after those tax advantages again. The insurance industry is getting this attention from Washington because of structural changes in the U.S. economy that have redirected household savings into the hands of institutional investors instead of local bankers who tended to invest in their communities, Ms. Whitehead contended. Insurers can redirect some of this money back to communities, she said, either directly or through a relationship with the banking sector. Whether one agrees with her specific approach to reinvesting in communities,we certainly think she has given the industry -- and its regulators --something to think about and another good argument for allowing discretion in investment decisions.") It is also worth noting that while the number of registered voters in these cities declined since the previous gubernatorial race by 33, 144, the percent of registered voters who cast ballots in these cities increased from 46.9% to 50.2%. (Source: Asbury Park Press.) The political dimensions of the new global economic paradigm may give unexpected economic clout to the same African American churches that were the subject of last November's political controversy. See Margo E Williams, God's business: The African-American church is emerging as the best hope for economic development in the city, Corporate Detroit Magazine (October, 1993) ("[According to] Detroit tax attorney Greg Reed, who has written a book for churches involved in business...: "They can do anything that private enterprise can do through a community economic development corporation.").

the colonial perspective is, if noting else, our own; and it is one of economic and political development in the context of a relationship with the British would empire. Moreover, certain lessons of our early history are very powerfully impressed upon the way all of us think, and therefore act. My objective in discussing this history is not historical, but rather to build on the framework of our shared history as a heuristic tool for conveying the political and economic principles that are shaping our current challenges.

The common lessons of our colonial past are know by nearly every American school girl and boy. For example, young master Whitehouse associates the American colonies with democracy, with religious and political freedom. Many Americans also associate the colonial character with a kind of free wheeling commercial energy and enthusiasm, and an environment in which the colonialists were left to pursue their business interests without government (*royal*) regulation.[22] The Boston Tea Party was, after all, at least as much about taxes as it was about representation.

Thus, second only to the concept of democratic government, we often accept the idea of freedom *from* government, of the independence of business from government interference, as part of our core revolutionary heritage. This theme is often said to be central to our economic growth and prosperity, both before and after the revolution. The fact that the greatest and most revolutionary economic work of all time, Adam Smith's *An Inquiry Into the Nature and Causes of the Wealth of Nations*, was written 1776, only reinforces the association between our revolution and the principles of "self-interest" and laissez fair capitalism.

Colonial prosperity, however, did not develop because the colonist's adhered to abstract principles of freedom and laissez fair. Democracy and self rule helped the colonies prosper. But we should not be confused. Colonial democracy was not a system that governed in one sphere -- that of government -- while free private enterprise was allowed to go its own way. It was not even a system in which private enterprise was subordinated to overreaching democratic values. Rather, ***the colonies themselves were the private enterprise;*** [23] and the principles of self-governance associated with

22 See Edmund S. Morgan, The Birth of the Republic, 1763-1789, 10-11 University of Chicago Press, Chicago (1956) ("Administration of the colonies was left to the King, who turned it over to his Secretary of State for the Southern Department (whose principal business was England's relations with southern Europe). The Secretary left it pretty much to the Board of Trade and Plantations, a sort of Chamber of Commerce with purely advisory powers. The Board of Trade told the Secretary what to do; he told the royal governors; the governors told the colonists; and the colonists did what they pleased...The British Empire was inefficient, but its inhabitants were prosperous, and they were free.").

23 See Charles M. Andrews, The Colonial Background of the American Revolution, 6, Yale, New Haven (1958) ("The colonies began as "private estates, the proprietors of which, both corporate and feudal, were endowed with wide powers and privileges, conferred upon them by royal charter.").

colonial America were extensions of the corporate charters authorizing these private companies.[24]

Virginia's famous Jamestown, for example, founded by the Virginia Company of London as a commercial enterprise, used its charter of 1612 to establish a representative assembly for governing the "towns, hundreds, and plantations" of the colony. This principle of self-governance was continued when the Crown took over after the fall of the company.[25] Even more importantly these principles of governance remained the model for the Crown even when it began revoking charters and turning the corporations and proprietary colonies into Royal colonies to be operated according to a common plan.[26] In short, our political traditions are intimately bound up with their corporate and economic origins.

Today we look back with pride to the colonial roots of our democratic society, but we seldom remind ourselves that our political institutions began because they furthered more fundamental purpose of society; namely economic prosperity. It is not a mistake to associate the principles of independence guiding the American Revolution of 1776, with those principles of free markets expressed in the ***Wealth of Nations*** of 1776. It is only a mistake to forget the corporate origins and the economic motives of the colonial fight for independence. True, the colonies were fighting for free markets – free markets for the colonies as an economic institution. The purpose of the colonies had been, and by the time of the revolution, still was the production of wealth. In a very real sense the colonies were private sector corporations fighting for Adam Smith's free markets. Colonial political leaders saw themselves as representing the corporate and business interests of the whole colony. The corporate nature of each colony, the corporate purpose of the representative assemblies, and the collective pursuit of business objectives for the colony as a whole was taken for granted.

It would be may years and a long gradual evolution before American business and American government would divorce themselves from each other. Our

---

[24] *Id.* at 31-32 ("Legally, a colony was always considered an inferior and subordinate corporate body, similar in type to the gilds, boroughs, and trading companies of England, all of which exercised self-governing powers....").

[25] *Id.* at 34 ("That which happened in Virginia happened elsewhere also, but under other conditions. In the charter of each proprietary colony–in the same instrument which erected the territory into a seignory and placed at its head "a true and absolute lord"–was introduced the provision, seemingly of small moment at the time, that the proprietor should have the power to make laws with the advice and assent of the 'freeholders[]'...") See also *Id.* at 35 ("There was nothing either philanthropic or specially broad-minded in the granting of self-government to a royal colony, for the principle underlying it partook of the nature of a business proposition.").

[26] Only the corporate colonies and Connecticut and Rhode Island remained completely proprietary and self- governing. The Maryland and Pennsylvania colonies were returned to their owners in 1694 and 1715, but still remained semi-royal in form. See Andrews *supra* at pp. 24-25.

new federal constitution placed many limits on the federal government, and created **a federal government of enumerated powers;** *but placed very few restrictions upon the states.* In fact, it took a civil war, three constitutional amendments, and what has been called the second constitutional revolution, to assert the authority of the Federal government over the states with regard to the abolition of slavery and equal rights for freed slaves.[27] In asserting these limitations on state rights the language of the fourteenth amendment is not restricted to just the rights of the former slaves. In the first case to reach the Supreme Court following the fourteenth amendment, the court upheld the right of a state to grant an exclusive charter to a company engaged in the slaughterhouse business in New Orleans.[28]

It was only as we moved into the twentieth century, however, that the Supreme Court came to accept the growing view that private business was completely outside the organizing and coordinating role of the state. This position has become associated with a term – Lochnerism – taken form the name of the case in which the Supreme Court enunciated the new separation of government and business.[29] This case is now one of the most condemned cases in the history of the Supreme Court. Lochnerism has come to stand for the idea that the state has no right to interfere or adjust market forces; and that such interference violates private rights of contract and property.

As this new, and quite foreign, concept took hold, democracy was removed farther and farther from the organizing principle of business. The great corporations were claiming their independence. It would take the great depression and a third constitutional revolution for our government to reassert its role in regulating business. But this revolution was fought at a national level over the regulation of national economic policy, and in the context of very powerful national corporations. Franklin Delano Roosevelt's speech accepting

[27] Amendment XIII abolishes slavery and Amendment XV forbids restrictions on the right to vote "on account of race, color, or previous condition of servitude." Amendment XIV provides that "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." A line of Supreme Court cases stretching into the 1960's and 70's has gradually interpreted this language, through a theory of "incorporation," to make many of the specific protections and guarantees of the Bill of Rights applicable to the States. The first, fourth, sixth, and eighth amendments are now held to apply to State governments.

[28] See The Slaughter House Cases, 83 U.S. (16 Wall.) 36 (1873) (The dissenting opinion cites Adam Smith as authority for the idea that government, not even state government, can not interfere in private business relationships.).

[29] See Lochner v. New York, 198 U.S. 45 (1905). It is condemned by both the left and the right, including Robert H. Bork (See The Tempting of America: The political seduction of the law, 44-49, Touchstone, New York (1990).) Lochnerism has come to stand for the idea that the state has no right to interfere or adjust market forces; and that any such interference violates the private rights of contract and property.

nomination for a second term expressed the context in which our political and economic institutions collided just over half a century ago.[30]

> "In 1776 we sought freedom from the tyranny of a political autocracy – from the eighteenth century royalists who held special privileges from the crown. It was to perpetuate their privilege that they governed without the consent of the governed.... But, since that struggle, man's inventive genius released new forces in our land which re-ordered the lives of our people. The age of machinery, of railroads... mass production, mass distribution – all of these combined to bring forward a new civilization and with it a problem for those who sought to remain free.
>
> For out of this modern civilization economic royalists carved new dynasties. New Kingdoms were build upon concentration of control over material things. Through new uses of corporations... the whole structure of modern life was impressed into this royal service.
>
> There was no place among this royalty for our many thousands of small business men and merchants who sought to make a worthy use of the American system of initiative and profit.... The savings of the average family, the capital of the small business man, the investments set aside for old age – other people's money – these were tools which the new economy royalty used to dig itself in.... Throughout the Nation, opportunity was limited by monopoly. Individual initiative was crushed in the cogs of a great machine. The field open for free business was more and more restricted. Private enterprise, indeed, became too private. It became privileged enterprise, not free enterprise...
>
> The royalist I have spoken of – the royalist of the economic order have conceded that political freedom was the business of the government, but they have maintained that economic slavery was nobody's business... These economic royalist complain that we seek to overthrow the institutions of America. What they really complain of is that we seek to take away their power. Our allegiance to American institutions requires the overthrow of this kind of power."

Colonial democracy came out of and was primarily a means to support very practical economic objectives. Learning this lesson – that our democracy began as a practical approach for effectively attaining economic objectives – is a major step toward dealing with the global economic changes ahead of us. But there is more that our colonial history can teach us about international

30 Democratic Convention, Philadelphia, June 27, 1936. Roosevelt's famous "rendezvous with destiny" speech.

economic affairs as well. In fact, the reason school children learn about the colonies in terms of economics is because they can only be understood in the context of an overall British mercantilist trade scheme. Young master Whitehouse knows about New England's trade triangle; he knows that sugar, tobacco and indigo were crops of the colonial south; that southern New Jersey was a major iron producer and manufacturer throughout the revolution; and that Philadelphia and New York were major trading ports. He has learned about the colonial economics, not so much colony by colony, but according to the major characteristics of each colonial region. He knows these regional differences, and has learned that each region developed a different character as it organized its entire colonial structure around, not abstract political ideals, but around its unique economic foundations.[31]

Young master Whitehouse, with his 300 year old regional economic world view, envisions a world in which democracy is a handmaiden (*handperson*) of economic prosperity -- a means for a people with unique skills and resources to organize their society in order to maximize wealth. He does not yet understand the concept of the separation of government and private enterprise. He has not studied the concept of a national economy in which the entire nation buys standardized goods from, is employed by, and invests its savings in the same large national and international corporations. [32] He is not aware to the twentieth century's "national bargain" in which we adopted the large corporation as the centerpiece around which economic activity, in virtually every region of the country, would be organized as a national concern.[33] In short, he is better prepared than many "modern" political

---

31 See Andrews *supra* , The Colonial Background of the American Revolution (Yale, New Haven, 1958) ("[I]n the process of adjusting themselves to their new environment in temperate, semi-tropical, or tropical zones, they presented marked peculiarities and wide contrasts in modes of settlement, forms of agriculture, and conditions of social life, Furthermore, as they added to their numbers...they exhibited ever more clearly marked group distinctions and variations, which now we recognize as those belonging peculiarly to New England or the Middle Colonies or the south. " Compare Edmund S. Morgan, *The Birth of the Republic*, 1763-1789, pp. 4-13 (University of Chicago Press, Chicago, 1956) ("[I]n spite of their divisions they did have much in common... This widespread ownership of property is perhaps the most important single fact about the Americans of the Revolutionary period. It meant that they were not divided so widely between rich and poor as the people of the Old World....They also enjoyed a common privilege the meaning of which was more difficult to determine: they were all subjects of Great Britain....For Americans the great thing about this empire, apart from the sheer pride of belonging to it, was that it let you alone."

32

33 In this bargain we agreed to ensure the profitability of these large corporations in exchange for the affluence and world power that came from corporate oligopolies and their domination of the organization of standardized production. See Robert Reich, The Work of Nations (1991) ("In return for prosperity, American society accepted the legitimacy and permanence of the core American corporation.") Compare Robert L. Heilbroner's classic, The Worldly Philosophers (3rd Ed. 1967) ("[I]t is also evident that the great oligopolies are not yet an encrusted economic feudalism and that their very size leads not only to economic problems but also to some far reaching social benefits. In short, we seem to confront a form of economic power great with possibilities for economic good or evil, which is not yet "rationalized" within an overarching

economists for the realities of the emerging global economy in which trade and investment flows will bypass national boundaries.[34] His colonial model of regional economics and politics can also provide mayors, freeholders,[35] and governors with a valuable framework for success in an age of global economic change.

The perspective of 1776, is a good one to reinforce the lesson that economic and political structures are not forever. The world does change; and today it changes faster than ever before. In some areas of the world economic growth is 30 - 40% a year; and mere cities have become world economic powers.[36] But these changes are increasingly directed by specific patterns of economic organization and activity within individual states and regions. City and regional planners have become aware of a new historical reality, and are beginning to recognize the emergence of a powerful new economic pattern across the globe.[37] The economic and political achievements of these state/business partnerships are among the most impressive and original of our age. But resistance to this "new" economic pattern is strong; and change is the most difficult for large institutions who grew large in an age when size was a necessary complement to independence.

But the very independence from which this resistance comes is itself a result of a corporate externality -- of an economic structure chosen by our political

---

philosophy of political economy nor regulated within a system of institutional controls. In the end, of course, unless we are resigned to a kind of business neo-feudalism, the new corporate powers must find a legitimate place within, and not above, their larger social and political matrix. What that place will be, how their responsibilities will ultimately be defined, and in what way the new balance of economic power will be achieved are questions which today--and surely for a long while to come -- will remain among the crucial problems with which modern capitalism must be concerned.").

34 The economic prescriptions for survival in this single market have now become commonly accepted, although Michael Porter, author of "The Competitive Advantage of Nations," recently said that his ideas had been better received by foreign governments than by Congress. See Dan Morgan,THINK LOCALLY, WIN GLOBALLY; Harvard's Porter Pushes Regional Clusters as the Key to Industrial Competitiveness, *The Washington Post*, p.l, Financial Section (April 5, 1992).

35 The colonial term still used in New Jersey for elected county government officials.

36 See Rajendra S. Sisodia, *supra*.

37 Economic and political theory often follows the reality of real world events. When Adam Smith wrote *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776, its power did not come simply from an idea; rather it came from expressing organizing principles that accurately represented the new economic realities of his day. Today, we also have new economic realities and those realities include the active role of government, not in regulating the economy, but creating and organizing an economy. The tremendous growth of state and local economic development commissions and agencies around the country is one indicator of this activity. These agencies are being established in many forms; and, appropriately. many combinations of public and private involvement. But most of all they represent cooperation between the public and private sectors. These agencies are engaged in planning, marketing, investment and asset allocation activities in a scope and dimension that traditionally has been the domain of only major corporations.

sector. Corporate independence became the way of things, not because it is the natural, or the only way of things -- but because the political sector chose to provide it with a structure within which it could operate independently. The political sector in a democratic society is influenced by all of its members, and its "economic royalists" may be more influential than most in determining society's economic course. But once the theory of separate world's for business and government is accepted, once state political leaders forget their roots, once they have pulled back from a view of themselves as managers of wealth creation, a new economic pattern, a new institutionalization develops within that new framework. Still, the institutions to support the "independent" corporate model took time to develop as Roosevelt's address in 1936 makes clear. The withdrawal of state governments from economic management created a large gap; and the Federal government stepped in to ensure that neither the separation nor the withdrawal ever became total.

Business organization still demanded teamwork, cooperation and the pulling together material, technological and human resources. But in the independent corporation this cooperation is skewed toward the coordination of internal resources only. So market control and expansion become a natural response. Self sufficiency, size, and business strategies built upon domination, become the leading models of business organizations. Nevertheless, our corporate giants were never really independent and never self sufficient. First of all, Roosevelt's New Deal not only began the social welfare state, but it began the age of corporate regulation, and it gave us our guided capitalism of the last fifty years -- Federal government management of business cycles, and levels of output and employment.[38] The federal government had taken responsibility for the proper functioning of the economy by the deployment of monetary controls, the tax and spending powers of the federal government, and the social safety net features of our current system.[39]

While the changes enacted by the New Deal are often seen as very sweeping, and as a reassertion of government's role in the economy, the New Deal also institutionalized the concept of a national economy built upon the large national corporation. Over time, our underlying financial structure also changed. And today our financial institutions pull money directly and efficiently from the savings of every American and apply them to the needs of our national corporations. Institutional investors now invest directly and exclusively in the money and capital markets. What is new to this support structure, however, is that institutional investors are suddenly the dominate source of capital and investment for these markets. Something quite remarkable happened to our financial system in the last forty years, without

---

[38] See the Employment Act of 1946 in which Congress established that it was "the continuing policy and responsibility of the Federal Government... to promote maximum employment, production, and purchasing power."

[39] The growing debate over welfare reform necessarily revolves around whether the tension between a) the current idea of the public safety net in which government passively redirects wealth to those whom the free market misses; and b) active government involvement in the coordination of societies resources toward wealth creation .

any conscious plan, and purely as a by-product of our independent corporate structure. American household savings is increasingly going directly into pension, 401(k), insurance, and mutual funds, without ever going through a bank. This is significant because **our federal institutions (e.g., the Federal Reserve) are only geared to regulate the economy through the banking system.**

In 1950, pension funds held less than one percent of this country's equity. Today, pension funds hold about one-third of our equity assets; and total institutional investor holdings are 60% of the equity market. The growth has been dramatic, even in the last decade. In 1981, institutional investor holdings were only 38% of the equity market; in 1986, the percentage was 44%; and by 1990, was still 53%.[40] Now that global economic forces are changing the face of our economy, our financial system, which has almost completely transformed into a vehicle for the support of the old national corporate structure, is being asked to change. But institutional investors are a more conservative lot than entrepreneurs; and as a whole refuse to change their traditional focus on the capital markets. The result is a financial system with a pronounced structural bias in favor of the old corporate system; in favor of independent corporate business enterprises that can obtain capital through the capital markets. As a result, the fiduciary financial system, designed under the old model, is finding it difficult to work with state and local governments or to address the needs of small business enterprises that are better suited to the classic direct lending approach of the old banking structure.

Both our economic and political sectors are scrambling to convert our old corporate economy, one with a significant focus on the production of military goods and services, into an economy focused on a new model that can improve our standard of living and quality of life. Conversion of our released military production alone will require a wide diversity of productive outlets for the released energies of the military economy. Decades of our old national corporate economic model encouraged economic centralization. Our financial system responded with a more centralized investment structure. And not only did we centralize investment control, but we institutionalized investment rules skewed in favor of the capital markets of the larger, more visible corporate economy. This arrangement was mutually beneficial -- the investment world obtained better earnings figures from the economic concentration that it financed, as it becomes increasingly concentrated itself -- but it did not produce an economy prepared for global competition.

Economic conversion will require both diversity of economic opportunity and diversity in the control of capital if all of the resources of our society are to be utilized effectively. And here is the central problem. Our current financial structure has concentrated asset allocation control in the hands of institutional investors. **If the institutional bias against diversification continues, our investment structure will be an obstacle of economic conversions needs.** And the primary reason this bias continues is that the assumptions underlying

---

[40] Brancato, supra.

the old corporate paradigm have been institutionalized into a legal and financial framework which fiduciaries still interpret as mandates against diversification. However, there is hope. If it is folklore that economic growth is better served by the old model of corporate growth, and if fiduciaries recognize the folklore character of their operating assumptions, they will begin to change. Our economies need this change because fiduciaries are now critical to the allocation of investment resources. State and local governments are new players in the economy because the new global economy requires a regional investment focus, not a national focus; and it requires diversification not concentration. But success requires not merely the coordination force of our state and regional governments; it also requires a financial system that is integrated into and supportive of these efforts.

It can no longer be denied that the structural bias of the institutional investor negatively affects not only the small business sector, but also entire communities that depend on direct lending for economic growth. Despite a growing recognition of these negative effects[41], this bias has been exceptionally difficult to counter. First, the very speed with which our new global economic structure is being born means that the last half century gives us no precedent for objecting to the continuation of past fiduciary practice. In 1993, the institutional investor sees him or herself as merely continuing an historical practice. But there are two ways to awaken the institutional investor from her or his habitual recitation of the mantra of investing on the national corporate model: 1) to convince the fiduciary of the economic benefits of the new model; and 2) to show that continuation of practices begun when fiduciaries played only a minor economic role are not appropriate now that the institutional investor is the dominate investor.

One difficulty in overcoming fiduciary bias is that this bias is justified by what is seen as an "objective" decision making process. The new model, is a looser confederation than the old corporate kingdoms. It is composed of faster moving small companies, who have traded the large corporate parent for the coordinating role of the state. Fiduciary investment decisions are based on average risk and return information; but as yet there are no averages. By fiduciary standard procedures, therefore, sanctioned by law and regulation, inner cities, and even small businesses, as entire investment categories, are objectively evaluated out of the prudent portfolio.[42] Bias is not acknowledged

---

[41] See Policy Reader on Public Pension Fund Economically Targeted Investments, The Center for Policy Alternatives, (August, 1992). Also see Economically Targeted Investments, An ERISA Policy Review, Report of the Work Group on Pension Investments, Advisory Council on Pension Welfare and Benefit Plans, United States Department of Labor, (November, 1992).

[42] East Oakland, the inner cities of New Jersey, and depressed communities in general should take heart from the new willingness of institutional investors to take risks in poor areas outside the country. See Risks, Rewards And Razzmatazz, *Investors Chronicle*, Finance/Business section (October 15, 1993) ("Fund management groups have latched on to a new story and they're busy telling anyone who'll listen. The essence of the message is that private investors can make money in all those far-flung places which most of us had previously associated with poverty, political repression and stagnant economies.These countries in Asia, Latin America and Eastern Europe are being marketed as a major investment opportunity for the 1990s. This year activity

because the criteria is "objective", sanctioned by law, and operated not for private gain, but for a purpose that has nearly universal public acceptance; namely, "the exclusive best interest" of the participants in the funds.[43]

Thus, there are two hurdles for those who instinctively feel that investment capital should serve the needs of our nation's economic health. These two hurdles are 1) tradition, and 2) the obligation of any fiduciary to do the best that he can for "his people" – the employes, retirees, and beneficiaries of his fund. With respect to tradition, let me say that the new economic model is the traditional and conservative economic model, and that it does not imply social investing. *The contributions we make in the framework outlined in the White Paper to the economic theory of the economically targeted investing "ETI" debate is rather, to advocate fiduciary support of diversification and of the new role being played by state and local governments in community wealth creation.* In a sense it is to advocate traditional economic values consistent with the corporate democracies on which our country was funded. Modern day corporate democracies on which our country was founded. Modern day corporate democracies should not be any less conservative, or any less entrepreneurial than the corporations fiduciaries are comfortable supporting. Further, economies that become diversified and have the support and backing of state and local governments, will have less aggregate risks than the former aggregate risk of isolated smaller enterprises without stable sources of long term financing.

State governments will have an increasing intolerance of a fiduciary investment structure that distorts the allocation of American savings pursuant to artificial rules of the game. The new economic participation of state and local governments does not eliminate the value of large corporations. But it does equalize the playing field, and open up opportunities to the entire society. Also, to the fiduciary who argues that risk management requires that he or she stick with the old corporate kingdoms, I say this: **it is the unchanging institutional practice in changed financial and economic world that represents the real break with our traditional values of competition, economic growth, and risk management.**

Lets look at the "traditional" fiduciary bias against the inner city, or against small business. **Traditionally, this bias did not matter because the institutional did not control large amounts of capital,** and was never "objectively" evaluated. To a large extent, it is the continuation of this past fiduciary bias that actually creates today's "objective" criteria on which investment diversification is avoided. How can practice create its own justification? Simply. Once money begins to systematically flow out of a

---

has accelerated still further with fund managers practically falling over each other in the stampede to launch new funds.").

43 See Herbert A. Whitehouse and Frank Morisano, "Old Man Potter, Pension Fiduciary, Red Lines South Central Los Angeles," *The ~id-Atlantic Journal of Business*, Seton Hall University, (June, 1993) (Demonstrating that "economic investing" in the interest of the corporate plan sponsor is a standard, and to an extent a justifiable, practice of corporate fiduciaries.).

community the objective risk will increase for any expected level of return.[44] All objective information available to the institutional investor -- that is, information on the averages -- confirms this. The only solution, the only escape for this logical box of objective risk is to go beyond the information barrier, and for the structure itself to insist upon and encourage investment in worthwhile individual projects. This solution must be facilitated and encouraged by government action and for the following reason: Institutional investors are not entrepreneurs, they are fiduciaries; and they do not see their role as wealth creators, but rather as the trackers of returns made available by the entrepreneurs who do create wealth. Therefore, state and local governments need to establish the structure and framework for institutional investors to be comfortable with the risk and return of broad community investments. Without such government initiatives, the full participation in regional economic efforts desired by government to meet global competition will be restricted.

The model for this alternative investment framework is the relationship model of direct lending.[45] Unlike the capital markets, and because of the increased flow of parallel banking system monies through the capital markets, banks now

---

[44] See Whitehead, *supra*. See also, Selwyn Whitehead, "Testimony Before the House of Representatives of the United States of America, Insurance Industry Redlining Practices Hearing" Subcommittee on Commerce, Consumer Protection and Competitiveness, (March, 1993). In this testimony, Ms. Whitehead, recommends the establishment of an urban economic empowerment investment fund to facilitate the movement of institutional investor assets into small business and the inner city. This fund, expected to be launched in 1994, is known as C.R.E.D.I.T. (Common Resources for Economic Development Investment Trust). C.R.E.D.I.T. is built around the concept of providing a diversified portfolio of smaller bank investments to institutional investors as a way of redirecting institutional funds back into community development. These investments will include short and long term debt to these banks, equity positions, as well as coordinated administrative services arrangements to directly utilize the direct lending expertise of banking institutions in small business and community development. Compare Geoffrey Scotton, ONTARIO FUND READY TO FLY: NDP to unveil revised venture capital program, *The Financial Post* (November 18, 1993) (...Ontario's NDP government is expected today to unveil its Ontario Investment Fund, intended to invest in small- and medium-sized companies that have trouble getting capital.... First planned to be a S2-billion fund drawn largely from public-sector pension funds, it is now expected to be S 50 million. Heavyweights including Scotia Mcleod Inc. chairman Gordon Cheesbrough, Bank of Montreal chairman Matthew Barrett and Bank of Nova Scotia vice-president Robert Brooks are among the group that will join Premier Bob Rae, Economic Development Minister Frances Lankin and Finance Minister Floyd Laughren for the announcement. Also involved in the new fund will be Goldman Sachs Canada and Canadian Imperial Bank of Commerce. The fund is expected to include a number of smaller, so-called expert funds in such areas as biotechnology, telecommunications and the environment. The initiative is expected to be funded 60% by the private sector and 40% by the province.").

[45] See Randy Barber, President, Center for Economic Organizing, Testimony before the ERISA Advisory Council Investment Work Group, (June 1992) ("Herb Whitehouse may well be correct when he suggests that this country's regional and local banking structure can provide the bridge from the national capital markets (in which pension investors participate almost exclusively) for recycling pension dollars back into the communities from which they come and in which participants and beneficiaries live.").

need borrows as much as the borrows needs a bank. Individuals and small business have resources that are idle because they are truly cut off from the given and take of the large corporate market place. We have all seen the waste of resources in the inner city for many decades. The recent layoffs of middle management and highly trained technical people over the last five years illustrates the same kind of waste -- it is only just now affecting the white middle class living in suburbia. The structure of direct lending allows the individual lender to evaluate an individual project, home or business and to make an informed determination that may put these wasted resources back to work.[46] Government can reintegrate the resources of its community into the production of wealth if the integration is done at a level that is geographically small enough to coordinate, and under a "corporate" mission that accepts, the objective of wealth creation rather than safety net administration. Such a wealth creation mission by government will reverse the credit problem resulting from a structural flow out of small business and inner city communities. Why should an institutional investor diversify into an entire economy? The answer is that when government takes the diverse resources of its community under its umbrella it makes the failure to diversify an unnecessary risk for the institutional investor.

To a large extent this diversification should exist without state government as an economic partner. The fiduciary's own science, modern portfolio theory, tells her or him that the most efficient portfolio is a diversified portfolio. If his or her investment world were not closed to opportunities outside of the national corporate paradigm, portfolio theory would already be moving more quickly to recognize that its old restricted investment approach entails the

[46] See Economic Policy, EXPERTS DIVIDED ON WHETHER FEDERAL GOVERNMENT HAS VENTURE CAPITAL ROLE, Daily Report For Executives, The Bureau of National Affairs, Inc. (November 17, 1993) ("William Wetzel, director of the Center for Venture Research at the University of New Hampshire, Durham, N.H., said he does not believe that the federal government can match the scale of private capital in the market. He added that direct public investment most likely will not come up with the know-how needed to propel fledgling firms forward, as would private venture capital sources.... Wetzel suggested that the government act as a catalyst for investment in new high technology firms.... He also suggested that the government play a facilitating role, rather than a direct investment role, in creating venture capital. Wetzel recommended that the government underwrite for the next three years the operating expenses of existing venture capital networks that 'make a market' for what he termed 'the invisible capital market' or 'business angels.' This market is made up of about 2 million self-made, high net worth individuals who have the money to invest in new firms. Thomas Stanton, attorney at law in Washington, D.C., agreed that if there is a role for government, it should be in acting as a catalyst to investment. 'The key is to target investments, and the question is where can the government make a difference,' he said." Compare the initiative being proposed by the United States Department of Labor Advisory Council for a clearinghouse or network for economically targeted investments. An analysis of this proposal can be found in the "Report of the Work Group on Economically Targeted Investments," dated November 1993. Also Compare Richard Salkin, Group forms so venture capitalists are accessible, *Business Journal-Jacksonville* (October 22, 1993) ("Most venture capital companies are looking to invest in existing businesses and their minimum investment is large, in the millions of dollars[.]... For small businesses, a better source of capital is what I call angels-- small individual investors looking to invest maybe a quarter of a million dollars.").

taking of inappropriate risks. Further, the old structure of isolated, independent corporations prospered partially because fiduciaries directed our national resources under their control to finance its growth. Just as money flowing out of the inner city and small business increases risk to those investment, money flowing into the national corporations decreased the risk of each additional investment there. But as state and local governments begin to assess their old role in economic affairs and actively focus on the productivity of total community resources, fiduciaries will have to reexamine the patterns and flow of their investment activity. This reexamination will recognize that long term gains in equity have been fueled by a steady flow of new investment monies **due, not to the inherent superiority of capital market investment opportunities, but to an accident of structure.** Fiduciaries will quickly see the need to at least hedge against their bets on the old structure.

Moreover, despite institutional investor hubris, the continued existence of banking and the returns on investment still available to bankers are evidence that the relationship model of investment continued to attract investment capital, even before any models of total cooperation began to take shape. Diversification into the "relationship sector" not only provides comparable return, but it introduces an element of overall risk reduction. This risk reduction occurs simply because participation in the U.S. capital markets reaches only half to the production economy. It is also clear that the economic health of the capital markets moves differently than the economic health of the non-market economy. In addition, improved computer and communication technology give the small boutique a whole new dimension as we move into the world of the "virtual corporation." This clear trend in business organization was beginning even before the end of the cold war and will only be reinforced by the need for economic conversion of military production.[47] Institutional investors who refuse to diversify are simply gambling on the continued domination of the large corporation – the economic equivalent of the T. Rex and the brontosaurus – without hedging for the possibility that a smaller, faster species of company, now being nurtured with the assistance of a new incubator – the state – may win the economic evolutionary race.

Institutional investors will be needed to provide capital to those outside the old system; but government involvement in the new economy will help fiduciaries to reduce portfolio investment risks at the same time. Diversification will become both good investment and good economic policy.

---

[47] James F. Peltz, THE SOUTHERN CALIFORNIA JOB MARKET: LOOKING FOR LIGHT; THE DEFENSE FUND; LAID-OFF AEROSPACE WORKERS TAP INTO CONVERSION PROGRAMS, *Los Angeles Times* (September 20, 1993) ("The handful of defense conversion programs around the country – some of which provide seed money, small-business counseling or both – are just now being formed at the federal and state levels.... In California, the pot of available cash is small, especially compared to the thousands of people laid off from jobs with military contractors. But for an intrepid aerospace worker who has a good idea for a product or service that might sell well or blossom into a small business, there's a chance to grab a bit of the money that is available. One source of capital is a fund managed by the Economic Development Corp. of Los Angeles County, a nonprofit entity that recently amassed $1.5 million for defense conversion loans.").

This is a conservative fiduciary approach, properly distinguished from "ETI". **It merely calls for the fiduciary to cooperate with state and local governments to prudently ensure that investment of a fair share of its assets in small business and inner city community economic development.**

This "fair share" might be understood in some contexts by looking at where the pension or 401(k) monies come from. The source may be taxes, or it may be a pooled investment fund serving thousands of individuals in small employer plans, or it may just be a small employ plan funded by the contributions of a small employer. Investments are a way of providing capital to business. When a state's pension fund invests in a corporation's bonds or new issue equity it is providing the equivalent of a loan to that business, and at low rates not available to the individual and small business taxpayers who provide the funds. I submit that a state can reasonably conclude that it is not fair, and does not make good economic sense, to skew the investment of its citizens savings disproportionately against the productive sources of those savings.

We see the effects of this investment skew in the current economy. Economists characterize our lack of economic growth, and the now common corporate layoff, as a result of the large corporate sector's "productive over-capacity." For years our investment bias had helped large corporations to grow. Certainly, the constant investment flow to that sector helped to increase the market value of each prior investment. But the entire economy did not grow together. Demand has become a problem; both because of the poverty surrounding the corporate palaces, and because those individuals with money found that the new global competition could often better supply their consumer needs. Institutional investors will not be able to continue steering assets toward the old capital market structure if this excess capacity problem continue. This situation is remarkable similar to the demand and distribution of income problems faced when Roosevelt wrote of the "Economic Royalist." But then the solution was to increase demand on a national level -- social insurance programs and, most significantly, the demand of World War II. Today, we are looking for ways to invest the peace dividend, and increased social welfare expenditures will not help us with global competition. Today, the challenge is to provide alternative investment structures involving our currently uncoordinated, isolated an idle human resources.

In the late eighties, because these alternative structures did not exist, institutional investors continued to chase after existing assets when economic growth was no longer an objective. Thus, economic development was separated entirely from the portfolio's investment objectives. In short, the built in structure of favored corporate financing has resulted in economic distortions, and has filed as a model for economic expansion. The old structure has hurt small business, and limited the chances for new corporate competition to come out of growing small company firms. The solution to the large corporate sector's "productive over-capacity" is not to continue providing low cost money to that sector at the expense of the broader economy. Rather,

we need to equalize financial opportunities, encourage investment diversification, and grow the rest of the economy.

These objectives are not foreign to our free market ideals and values. It is merely folklore that the old model of the national corporation, the Armonk model, the model of the economic royalists, is the model of a free and open economy. Strong state and local government involvement in economic growth will enhance market freedoms, not limit market freedoms. And further, as we will discuss later in this White Paper, precisely because state government again accepts a charter to manage societies production of wealth, the political franchise will become significantly more meaningful. The term "disenfranchised" has for some time now, had a meaning that went beyond politics and into government. Now a state's involvement in economics will be come the tool to political empowerment as well.

Empowerment requires diversification, local control, and local autonomy. The national corporation is not the model of empowerment. But diversification requires the redirection of financial resources; and the institutional investors who control the allocation of resources need prudent tools to diversify into the entire American economy. For large corporate investments the portfolio manager has the "efficient" capital markets as his or her basic tool. The difficulty with the remaining economy is that each investment opportunity is too small be included in these "efficient" capital markets. Market information does not exist for these investment. But some have mistaken this information bias for an indication that the rest of the economy is inherently inferior. One such manager of a large east coast state pension fund indicated that his rational for this exclusion is that the economy outside of the capital markets is too risky, and that employees "would strongly resist any direction of their funds into the kind of investments undertaken by the banks."[48] This point of view is not unique. It is, in fact, the main stream institutional investor view.

But a state government concerned about total cooperation and the enfranchisement of its entire population will be less disdainful of the role of the banking function and the people and communities that it serves. It is exactly because of the inability of the markets to reach the broader economy that banks are considered to be an inherent good -- a necessary part of our financial system. Bank exist to provide the capital necessary for economic growth. They just provide this capital in the form of direct loans instead of the

[48] August 5, 1991, letter from Ronald Machold, Investment Director, State of New Jersey, to the author suggesting that state employees "would strongly resist any direction of their funds into the kind of investments undertaken by the banks." Note that the New Jersey State Investment Council codified its policies towards social investing in 1984; The Council adopted the following policy: "The Division of Investment should prefer investments in companies which advance the economic development of New Jersey, support alternative energy sources or are controlled by economically disadvantaged individuals, provided such investments meet the fiduciary standards of the Council and provide fair market returns." Compare *supra.* notes 5-6.

bond and stock transactions the portfolio manager uses to provide capital to the corporate economy.[49]

Direct lending is the historical engine of economic growth, the building of factories, and the creation of jobs. It is an engine that will play an important role in a new global economy. So why does the institutional investor look down on both direct lending and the economic sector dependent upon direct lending? Can the economy somehow be better off without direct lending? Can an economy be build around a financial engine that has an aversion to this kind of investing? Of course not. When pressed, the institutional investor will admit this. But she or he will say that the institutional investor has one role and banks another. This attitude is primarily a result of the quickly fading assumption that the phenomenal growth in institutional investor controlled assets over the last several decades was the result of objective market forces, not structure.

Today, state and local governments will no longer accept a capital market skew as desirable economic policy. In fact, state and local government involvement will change the structure on which institutional investors have relied. The institutional investor's preference for the status quo merely reflects a natural desire to retain its advantage. *Relative to the rest of the economy*, an ongoing net inflow of monies from the boarder economy into the capital markets works to the advantage of the designed intermediary for capital market investment. But structured advantage in the long run will produce only economic distortion, not economic growth. And a state government involved in the work of making its entire society productive will not tolerate structures, at least in their own pension funds, that work against the state's economic mission. The history of American economic expansion is a history of direct lending, and a more diversified ownership of wealth. Our banking institutions

---

49 Compare Kermit Hansen, Turn your town around, *ABA Banking Journal*, p.138 (November, 1993) ("All states have departments of economic development who work with towns and cities, but often they are "elephant hunters" who go after the big prospects that can provide 500 to 1,500 jobs at a clip.... Bankers are key to every successful example of revitalizing a community and 'growing' a new or expanded enterprise. They provide normal bank financing and support or help find other capital sources. They research bond issues, provide counsel on setting up co-ops, partnerships, municipal consortia, etc."). Also compare David E. Gumpert, Building your business foundation: resources to help you grow your company, *Working Woman* (November 17, 1993) ("Many would-be entrepreneurs don't need the $50,000 or more that banks typically lend and the $500.000 or more that venture capital firms invest. They may need only a few thousand dollars, or even just a few hundred dollars, for some equipment or inventory to get their business off the ground. In recognition of this fact, the SBA last year began its microloan Demonstration Project to lend anywhere from a few hundred dollars to a maximum of $ 25,000 to individuals starting business via non-profit community organizations with lending experience. During its first year, the program accounted for 330 loans worth a total of nearly $3.3 million; loans averaged about $ 10,000. Almost half of the funds went to businesses owned by women. In one case, a single mother of six on public assistance obtained a $ 475 loan to buy hair-care equipment to begin a home-based beauty salon. 'This program is making unprecedented headway in financing grass-roots enterprises in communities across the United States,' says SBA administrator Erskine Bowles.").

provide a practical link to that history and a resource for state and local governments.[50] In the emerging economic order, the existing network of community based and focused banks and new community development financial institutions will be important partners with state and local governments in the identification, allocation, and risk management of a state's capital resources. But the most significant result will be a new structure in which it will be in the interest of institutional investors to no longer remain isolated from the community and the economy at large. The alliance with independent and isolated national corporations was successful under the old structure – but only because of that structure. In the new structure it will be in the interest of institutional investors to work cooperatively with banks, and for banks to work cooperatively with state and local government.

Under the new economic model involving state government as one of the major economic decision makers, resources will have to be identified, objectives set, and strategies designed to achieve those objectives. One strategy that states have been using is to establish critical clusters of enterprises that can build on its existing strengths and resources. States will also be able to engage and direct available underutilized resources surrounding and complementing key regional corporations. Because the state will be actively involved in the economic life of the state, these now scattered resources can achieve the power of large scale team work and coordination that had been reserved to the national corporations. Even the large corporations will be better able to face global competition; and will benefit from trading in their old isolation for a new alliance. Because this new model is premised on the identification and integration of all resources in a community, it will increase diversification, provide overall risk reduction, and broaden economic competition. State governments, in cooperation with state and community focused banks, will provide an overall investment framework through which the disenfranchised can again make real contributions to economic growth.

While the old economic system aggregated wealth around its corporations, it also denied large segments of society a means to participate in wealth creation. the poverty of our cities is a major, but by no means exclusive example. Political attempts to address this poverty have failed. But today there is an opportunity to address this poverty because the opportunity is originating from economic motives, and out of the economic sector. And the change being sought is the active participation of our whole society in production. This means that the morality plays we enact need not be purely governmental. Instead, we can begin to reconnect our society, and all its resources, as we move to adopt the economic solutions necessary for facing our new global competitors.

---

[50] State governments can also work to alleviate a weakness of banks; viz., the elimination credit to otherwise healthy and credit-worthy firms when a bank fails or federal banking regulations require higher reserve ratios, and thus reduced risk.

We will not longer engage in modes of organization that separate and segment; and **we will no longer find it economically acceptable to isolate either the business world,** ***or the inner city.*** Instead we will look to teamwork, cooperation and integration as the best means to increase competition. The term that might best describe this new mode of organization is ***harmonization.***[51] While harmonization means an expanded scope it also means that primary economic activity will lose its national focus. Economic activity will be regionally based. When the new governor looks at New Jersey, she can no longer afford to see poor cities such as Newark or Jersey City solely in terms of the safety net obligation of government. When the current insurance commissioner looks at California he must continue to see the economic potential of cities like Oakland and Los Angeles and continue to press insurance companies to make both their products and investment vehicles affordable and available to all the state's citizens[52]. Whitman and Garamendi both must view their jobs as managing the harmonization of resources available to them for producing wealth. California and New Jersey and other states with comparable underutilized resources will begin to see in themselves the resources and the ability to match the Singapores of the world in wealth and power.[53]

---

[51] See Turner Charles Hampden, Tom Peters, Jay Jaikumar, The Boundaries of Business: Commentaries from the Experts, ***Harvard Business Review,*** p. 93 (September 1991)("As long as we see the world [through our old paradigms], we largely miss the organizing logic of Japanese management: to protect companies, but just long enough to let them build their capability to compete worldwide; to provide government direction, but just enough to free private companies to develop; to compete fiercely but also to cooperate closely. The ultimate goal of all these activities is to create harmony, what the Japanese call wa. By harmonizing what Westerners see as contradictions, a Japanese manager functions much like a judo fighter who uses an opponent's momentum against him.").

[52] See John Garamendi "Testimony Before the House of Representatives of the United States of America, Insurance Industry Redlining Practices Hearing" Subcommittee on Consumer Credit and Insurance, Committee on Banking, Finance and Urban Affairs, (April, 1993). In this testimony, Commissioner Garamendi, recommends the establishment of an insurance company Community Reinvestment Act, ("... it seems to me that your bill would be further enhanced if you also borrowed a feature from another banking law, the Community Reinvestment Act. Insurance companies are amount the largest financial institution[s] in the United States. Because of State regulation, they have escaped Federal regulations which require banks to be good corporate citizens and invest in all communities. Insurance companies may not make direct loans like banks, but they could purchase packages of loans to invest in targeted areas or directly invest in these areas. This feature, if added to your bill, could make capital more available for rebuilding the central cities and other distressed communities.").

[53] Compare Yeo, *supra* at note 16 ("A foreign ambassador paid a farewell call on me a few weeks ago. He gave me his views of Singapore which are mostly favorable, but he ended by saying that other cities like Kuala Lumpur and Bangkok are catching up. They too are building up their ports, airports and telecommunication facilities.... I listened carefully to what he said because he had no axe to grind. Of course he is right. Our position is never secure. When I met the Mayor of Zhuhai City three months ago, he asked me how long it would take for Zhuhai to catch up with Singapore. I did not know how to answer him. Zhuhai is growing at 30 to 40 per cent every year. At that rate they will catch up with Singapore in no time. In my heart, I thought, yes, you will sprint, but we have every intention to stay ahead. Of course, I could not say that to him. So I gave a diplomatic non-reply. But it is worrying, isn't it? How can we be

A lot has been written about the economic dimensions of the new global competition and the modes of organization which success depends; but almost nothing has been written about the implication for the the American political system. In fact, as we have discussed, the only commentary we hear about the impact of the new shape of the global economy is that economic success seems to come with the loss of freedoms that Americans will be reluctant to surrender. This White Paper has tried to show that a reconnection of state and local governments to the direction of their economic destiny is not foreign to our tradition. Further, this reconnection will mean greater economic diversity and not less; and this reduction in concentration, this opening up of the economy will, in turn, mean more competition and greater economic freedoms for the entire population.

But this reconnection will have direct implications for the management of government as well. It will mean that political office will become much more than the narrow circumscribed job of administering police and fire, roads and sewers, and the distribution of welfare and political patronage. Resource management, planning, and a new focus on investment will become critical. State political leaders will be judged more and more by their ability to achieve economic success.[54] Areas such as northern New Jersey and the Oakland-San Francisco Bay Area in California, each with major seaports, international airports, major rail hubs, world class universities, and major industries will not long suffer incompetent political leaders who can not transform this potential into economic prosperity. In short, state governments, which are now playing critical economic leadership roles, will need leaders able to run the state like a business. States will require leadership that brings economic planning and coordination in the office as a primary objective.

The new global economy will bring about transformations of not only our economy, but also our government. And while this transformation will evolve out of our own traditions and institutions it will not come about in obedience to either conservative or liberal ideologies. Conservatives fear that government planning will reduce long standing economic freedom. But the direction of global economic change is regional, and the impact of state and local involvement for the purpose of coordinating a region's resources will mean a more open, diversified and freer economy. These changes also have positive implication for our democratic traditions. Workers and entrepreneurs outside of the large national corporations will have a much greater stake in government. Democracy, which can become abstract and meaningless if

---

sure that we will always be able to stay ahead? We must always look outwards. Whatever we do in Singapore must pass the test of international competition.. .").

54 Robert W. Hornaday, Thinking about entrepreneurship: a fuzzy set approach, *Journal of Small Business Management* (October, 1992) ("Casson defined entrepreneurship as ' . .. taking judgmental decisions about the coordination of scarce resources'[]. He made it clear that this definition can apply to a 'planner in a socialist economy" or a "priest or a king in a traditional society'[].").

separated from the goal of promoting the general welfare will again be as important as it was when we fought a revolution over it.

Today the American economy is still a national economy; it still revolves around national corporations. These national corporations became international giants, many with operating budgets larger than most nations in the world. And for much of this century we have dealt with the work economy through these corporations. In this period, our entire economic system gradually transformed itself to revolve around, and to depend upon these corporations. State and local governments stood on the side lines, while many productive capacities also stood idly by. But global competition has brought about rapid change in our economy. We now recognize that corporations exist merely to fill organizational and coordination needs for society. They bring together the individual skills, efforts and knowledge. But corporations are primarily an organized combination of capital. While our financial system, including the preeminent role of institutional investors, supplied our national corporations with all the capital they required, much of the economic potential of our states and regions found it increasingly difficult to obtain capital. Because of this our states and cities began to undertake what has amounted an American economic revolution. America has reinvested itself, and found its own way to compete with the keiretsu, the "societies of business" centered around Japanese banks, and other foreign forms of cooperative economics. The way is the reconnection of our state and local democratic institutions to our economy. The Governors have begun to pull out their corporate charters. Insurance Commissioners have no less a responsibility.

We did not need to reinvent the House of Morgan. Our large corporations who would have been the beneficiaries of such an institutional change are not in need of stable financing. But our small institutions are in need of stable financing. Our economic community also needs to be able to provide support services to small business in much the same way that a large corporation gains efficiencies by providing those services to its many departments and subsidiaries. Similarly, the economic community broadly conceived, also needs other capabilities inherent in large corporations. For example, the total economic community needs to fund individual projects and operations based on the benefits provided to the total organization, and the expected benefits over time, even if this quarter's earning do not show a profit. These functions will be provided by government; but the dynamic of the global economy will move government closer to the people, and to the particular economic strengths and goals of states, cities and regions. The NAIC can and must play a pivotal role in reconnecting good government policy with good economic policy; utilizing the appropriate tools[55] and establishing the appropriate

[55] Some of which were offered by Robert A. Bailey, Michigan Insurance Bureau, as outlined in his "alternate draft of the NAIC Model Investment Law", dated December 6, 1993, in which he stated, "... These other regulatory tools are listed below. Any effort to develop a Model Investment Law must occur within the context of existing tools related to the same subject and must not allow the difficulty of coordinating the use of discretion among the several states and the NAIC to suppress the vital use of discretion." The tools listed by Mr. Bailey were

standards to yield a level of confidence to the regulator while giving the insurance company investment manager the discretion necessary to obtain an economically sound diversified portfolio.

regulatory mechanisms already developed or currently under development by the NAIC and included: Life/Health and Property/Casualty Risk Based Capital; Asset Valuation Reserve (AVR) and Interest Maintenance Reserve (IMR); Codification of NAIC Statutory Accounting Principles; Valuation Actuary Opinions/Cash Flow Testing; IRIS Ratios; Augmented Asset Reporting Requirements; FASB 115; and the Model Holding Company Law.

TESTIMONY IN SUPPORT OF H.R. 3298 (Property Reinsurance For Underserved Areas)

My name is Cary Cheldin. I am the executive vice president of Crusader Insurance Company. I have personally managed Crusader's underwriting for each of the past seven years.

Crusader is a publicly-owned, stock company which specializes in property and casualty insurance for businesses. Until recently, we operated only in California.

Of Crusader's 10,000 business customers, we provide affordable, admitted insurance to over 2,000 of Los Angeles' inner city businesses. Our company provides more insurance service to inner-city merchants than does any other company in the world, relative to size. The vast majority of California's inner city agents, brokers, and merchants will confirm that we have been an equally-active member and supporter of inner-city commerce since the day we started business nine years ago.

Our underwriting support of inner-city risks had always been profitable - that is until the 1992 civil unrest. As a result of our inner-city support, we sustained losses from that unrest which threatened our financial survival and depleted more than one-half of our total assets.

Although we are still committed to helping our current and future customers in these underserved areas, we are also bound by economic constraints and by a duty to protect and serve our policyholders and our public ownership.

Generally, the purpose of insurance is to spread the risk of loss so that any one loss, such as a civil disturbance, will not disrupt our individual or collective economy. Before 1992, Crusader effectively spread the risk of such civil disturbances through the purchase of reinsurance. However, the 1992 disturbance was the most costly in our Nation's history and was the largest in terms of both geographic extent and of financial impact. As a result, the required amount of reinsurance for our same inner-city property risks had increased five fold.

It is impossible for us to spread so much more risk. Therefore, we see only two, equally unattractive, alternatives: (1) drastically reduce the number of our inner-city customers or (2) impose huge rate increases on our inner-city customers.

Our inner-city customers have few other choices. Recognizing that these customers have historically been underserved by the private-sector insurance industry, most state laws provide them some form of FAIR plan assistance (aka: "Fair Access to Insurance Requirements"). However, realistic support and improvement of inner-city commerce can only be achieved with a diverse, voluntary marketplace, that is, a marketplace from which affordable property insurance can be purchased.

These facts were recognized by Congress in 1968 with the establishment of the National Insurance Development Plan. H.R. 3298 would restore that plan and provide the mechanism of financial incentive needed to develop and to maintain a diverse, voluntary marketplace from which inner-city customers could buy affordable property insurance.

Without such legislative assistance, I believe that Crusader, like many other businesses, will be forced out of the inner-city, an area that we have found to be otherwise attractive. With such legislation and the affordable reinsurance it offers, we will be able to expand inner-city operations, as will many other insurers.

I regret to report that many, mostly large, insurance companies have not supported this legislation. I can only surmise that such disregard reflects either equal disregard for the welfare of our inner-city communities, or reflects fear that their smaller competitors, such as Crusader, will be successful.

Please realize that Congress is considering "Natural Disaster Reinsurance" proposals which do not include losses caused by civil disturbance. Such proposals appeal mostly to large insurance companies. Nonetheless, the problems addressed by these proposals are not as vital as those economic problems of our inner-city communities. Far too often have the vital needs of our inner-city communities been subordinated to more trivial problems and desires of large insurance companies. The inner-city communities are not as able to handle effects of civil disturbances as most other communities are able to handle natural disasters. If congress is to address either problem it should first address that of our citizens who are in the more dire need of help.

My company and a few other small companies, which still embody the American entrepreneurial spirit, have underwritten inner-city risks for many years, and at greater levels of support than have been provided by many large insurers. This legislation would encourage those smaller companies to continue their inner-city support. Furthermore, by assuring access to secure and affordable reinsurance, H.R.3298 will eliminate the only logical reason for any insurer to avoid underwriting commercial property risks in inner-cities.

Thank you,

Cary L. Cheldin

May 18, 1994

ISBN 0-16-046700-4
90000
9 780160 467004